BUDGET 2009: AN ABOUT-FACE FROM NOVEMBER'S ECONOMIC STATEMENT

Janice MacKinnon

The 2009 federal budget's goal is to be timely, targeted and temporary. Of the $18 billion of new spending, most is on infrastructure projects that are temporary and will boost economic activity and jobs. Whether they will be timely remains to be seen. As well as more money for training and improvements to employment insurance, there are targeted tax cuts that represent good public policy but are not temporary. Whether the economy recovers in 2010 will depend more on what happens globally. The good news is Canada will emerge from this recession in better fiscal shape than any other G7 country.

Le budget fédéral 2009 se veut à la fois opportun, ciblé et provisoire. Il prévoit 18 milliards de dollars en nouvelles dépenses, dont l'essentiel ira à des projets d'infrastructures temporaires visant à stimuler l'économie et l'emploi. Il reste à voir si ces dépenses seront effectivement opportunes. On injecte aussi des fonds supplémentaires dans la formation et l'amélioration de l'assurance-emploi tout en réduisant sélectivement les impôts, ce qui va dans le sens de l'intérêt public mais n'a rien de temporaire. Quant à une éventuelle reprise de l'économie en 2010, elle dépendra de l'évolution de la situation mondiale. Quoi qu'il en soit, le Canada sortira de cette récession en meilleure santé financière que tout autre pays du G7.

Understanding the 2009 federal budget begins with the economic forecast, which is based on an average of private sector forecasts downgraded to make them more cautious: Canada's economy will continue to get worse until mid-2009 when a modest recovery will begin and pick up steam in 2010 (figure 1). The 2009 budget is essentially a short-term plan to stimulate the economy and promote consumer confidence so as to minimize the damage in the first half of 2009 and boost the recovery in the later half. The spending and tax policies in the budget are designed to be timely — capable of being implemented within the next four months — targeted at measures that will create jobs and boost spending, and temporary so as to avoid a long term-deficit. Its authors concede that if the economic forecast does not prove to be accurate, and the economy worsens, further stimulus may be necessary. Is the 2009 budget a timely, targeted and temporary response to the current economic crisis?

The budget is an about-face from the November economic and fiscal statement, which spoke of balanced budgets and controlling spending, a shift explained by political pressure from the coalition; a consultation process in which traditional fiscal conservatives, like business groups, urged spending; and a deteriorating global economic situation. At the G20 summit in mid-November, countries agreed to provide stimulus representing 2 percent of their GDP. In today's global crisis fiscal conservatives are hard to find.

The budget builds on the actions of the government and the Bank of Canada to improve access to financing for businesses and individuals. It takes further measures to ensure that private sector lenders and Crown corporations, which loan money to businesses, exporters and homeowners, have more money to lend. It also allocates $12 billion to support the financing of vehicles and equipment, a measure that should assist the struggling auto sector by helping to provide credit to potential customers.

The centrepiece of the budget is the $12 billion being spent over two years on infrastructure projects that can start this construction season. Some of the infrastructure money is for the "new" knowledge economy: $750 million for the Canada Foundation for Innovation, which funds research facilities, $2 billion for post-secondary education infrastructure, and funding for electronic health records and the expansion of broadband Internet service to communities not currently served. Although the environment gets short shrift, there is $1 billion over five years for the Green Infrastructure Fund and a Clean Energy Fund to promote technologies like carbon capture, which can help reduce greenhouse Gas emission on projects like the tar sands. However, most of the money is for traditional infrastructure: roads, buildings and bridges.

Rather than being targeted, the infrastructure money is being spread across almost every conceivable sector. There is money for parks, recreational facilities, railways, cultural facilities and heritage sites. The infrastructure projects along with the money being allocated for key sectors reflect regional balance. That is, the previously announced support for the auto industry, which primarily benefits central Canada, is balanced by money for sectors in other regions: agriculture, forestry and shipbuilding.

The diversity of the infrastructure projects in part reflects the fact that the majority of them are being done in partnership with provincial, territorial and municipal governments. These other levels of government have the lists of "shovel-ready" projects and the federal government has little choice but to accept them. With literally hundreds of different jurisdictions selecting projects it is likely that at least a few will be of questionable long-term value.

Another issue is that the projects have to be cost shared and some cities and provinces argue that they cannot afford to pay their share. The federal government will probably have to be flexible when it comes to deciding what constitutes "new" money for "new" projects. Some municipalities and provinces will likely merely repackage projects that have already been funded or argue that assets such as land constitute their contribution. However, this raises questions about the projected economic impact of the budget. It is projected that the budget will inject almost $30 billion into the economy, which represents 1.9 percent of GDP, very close to the G20 target. The budget, however, assumes that provinces and cities will fully cost share all projects. If this does not happen, then the boost to the economy will be less than what the budget forecasts. On the other hand, Canada, unlike many other G20 countries, is a federal state, and provincial spending to stimulate the economy also has to be taken into account.

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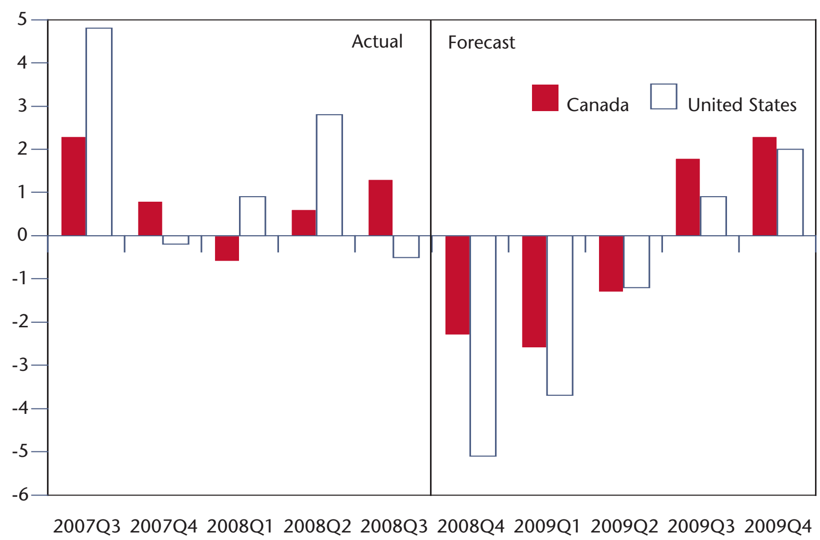
Another concern is about the timeliness of these joint infrastructure projects. Will the federal government be able to act quickly to establish criteria and approve projects so that they boost the economy this year, when stimulus is needed, rather than next year, when it may not be required? On the other hand, if projects are moved quickly through the approval process, will we find that in some cases there was not adequate due diligence and accountability?

Much of the infrastructure spending is on housing. There is money to upgrade and do energy retrofits on social housing. There will be new social housing for low-income seniors, persons with disabilities and residents of the North and First Nations reserves. There is financial assistance for first-time home buyers and for homeowners to make their homes more energy efficient. The temporary tax credit that will provide up to $1,350 in tax relief for home renovations will likely prove quite popular. Considering the shortage of housing for low-income earners in many parts of Canada, it is good social policy to invest in housing for low-income people. From an economic perspective, spending on construction boosts the forestry sector, which means a significant amount of the money spent remains in Canada.

Since most of the new money in the budget is being invested in infrastructure it is important to assess its economic benefits and whether the

FIGURE 1. REAL GDP GROWTH OUTLOOK (PERCENT)



Source: Budget 2009, figure 2.22.

investments pass the test of being timely, targeted and temporary. Whether the projects can be up and running in time to boost the recovery remains an open question. The projects themselves are a hodgepodge but they do meet the test of creating jobs and boosting spending: it is estimated that for every $1.00 spent on infrastructure, real GDP increases by $1.20. Also, Canada's infrastructure is in bad shape and investing in it today, when construction costs are lower than during good economic times, will bring long-term benefits. Finally a great virtue of infrastructure spending is its temporary nature. It is one-time spending that does not add permanently to the deficit. Hence, in 2009-10 the budget projects $18 billion in new spending; however, because most is infrastructure spending by 2011-12 new spending is projected to fall dramatically to less than $5 billion.

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Another dimension of the budget is the support for training and enhancements to employment insurance (EI). There is more money for training for EI recipients and those who do not qualify for EI as well as additional support for older workers, Aboriginal people and students. Graduate scholarships and internship programs have been enhanced and there is more support for apprenticeships. For EI recipients the benefit period has been increased by five weeks and the maximum benefit duration increased from 45 to 50 weeks. However, the variations in EI benefits from one region to another have not been addressed, and the assumption that the enhanced EI benefits will be phased out after two years seems unrealistic.

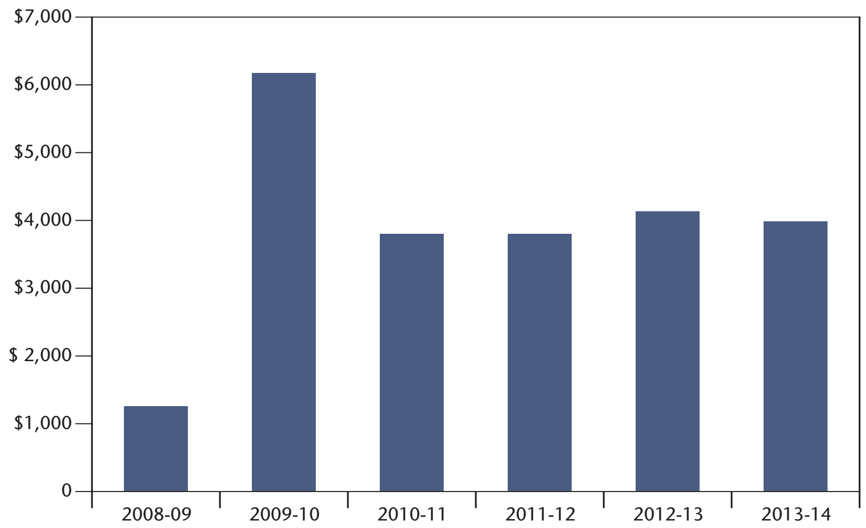
Although this is predominantly a spending budget, there are some personal and corporate tax cuts. The main corporate tax cuts are temporary, inexpensive and targeted to encourage investments, particularly in manufacturing and processing machinery and computers: a 100 percent capital cost allowance (CCA) rate for computers and a 50 percent CCA rate for manufacturing and processing machinery and equipment. Also, the income level for small business to benefit from a reduced tax rate was raised from $400,000 to $500,000, and tariffs on machinery and equipment were abolished to encourage business investment.

In terms of personal tax cuts, although the home renovation tax credit mentioned previously is temporary, the rest are permanent and are targeted to low- and middle-income taxpayers. The most expensive tax measures relate to income tax: raising the basic personal exemption from $9,600 to $10,320, increasing the top of the first tax bracket (a rate of 15 percent) from $37,885 to $40,726 and increasing the top of the second tax bracket (a rate of 22 percent) from $75,769 to $81,452.

More support for seniors is provided by increasing the Age Credit for income taxes by $1,000, a benefit that is fully taxed back at an income level of $75,000. By raising the level at which the National Child Benefit supplement and Canada Child Tax benefit are phased out, the budget provides more assistance to low-income families with children. And the Working Income Tax Benefit, a refundable tax credit that supplements the earnings of low-income families, has been increased by $580 million, which effectively doubles the benefit.

Are the tax measures timely, targeted and temporary? Most are timely: the home renovation tax credit is effective immediately and taxpayers will see the benefits of the income tax cuts by the spring of 2009. The personal tax cuts

FIGURE 2. COST OF PERSONAL AND CORPORATE TAX CUTS IN 2009 FEDERAL BUDGET (MILLIONS)



Source: Budget 2009, table A5.1.

are targeted, with 75 percent of the benefits going to taxpayers in the two lowest income tax brackets. This is important since low-income taxpayers are much more likely to spend the extra money rather than saving it or using it for a vacation. The main shortcoming of the tax cuts is that most are not temporary. In fact, since the permanent tax measures are indexed to inflation they will grow over time. By 2014 the tax cuts will cost about $4 billion per year (figure 2). On the other hand, these tax cuts are not nearly as expensive as reducing the GST from 7 percent to 5 and they are good public policy. Providing more support to low-income families and seniors helps to strengthen the social safety net, and supplementing the income of low-earning families means that there is an incentive to work rather than rely on welfare.

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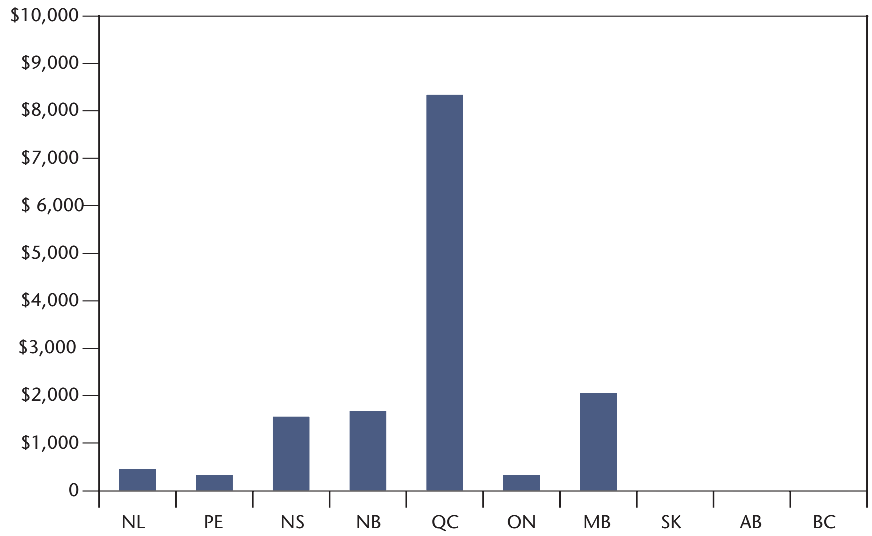
Another dimension of the budget is the changes that affect federal-provincial relations. The budget confirms the recent decision by the federal government to create a national securities regulator. After years of discussion the current economic crisis is an opportune time to drive home the argument that a national regulator would be more effective and efficient, and following the recommendations of a recent report on the subject, the government has tried to accommodate opposing provinces, notably Quebec and Alberta, by making provincial participation voluntary.

The budget also confirms the previously announced decision by the federal government to limit the increase in Equalization payments by linking them to economic growth. Since 2003 Equalization has grown by more than 50 percent, and the program, which currently costs about $14 billion, has been projected to cost almost $20 billion by 2010-11. As well as the cost to the federal treasury, such dramatic growth in Equalization has important implications for Ontario. While Ontario technically receives Equalization, the amounts are minuscule, especially in comparison to other provinces. In 2009-10, Ontario will receive $347 million in Equalization, while Quebec will receive $8 billion and Manitoba will get $2 billion (figure 3). Although it receives virtually none of the money from Equalization, 40 percent of the money for Equalization comes from Ontario taxpayers since 40 percent of Canadian taxpayers live in Ontario. At a time when Ontario is reeling under the weight of recession and deficit budgets, Ontario cannot afford to have money redistributed from its taxpayers to those in other regions, some of which are in better economic and fiscal shape than Ontario.

The budget also benefits Ontario by the decision to move the payment of federal transfers for health care toward a per capita formula and by the creation of a Southern Ontario Development Agency. While it is debatable whether regional development agencies are the best ways to promote economic and community growth, the new agency means that another $1 billion over five years will be transferred to Ontario. It might be argued that Ontario is getting special treatment in the budget because the Conservatives won more seats there in the last election and would like to increase that number in the next election. Nonetheless, it is also true that Ontario represents 40 percent of the Canadian economy, and the speed and magnitude of the national recovery will depend to quite an extent on what happens in Ontario.

Although Equalization payments have been capped, other transfers have not: transfers to the provinces for health care will increase by 6 percent and the transfers for post-secondary education and social programs will increase by 3 percent. I am sure some civil servants in the Finance

FIGURE 3. EQUALIZATION PAYMENTS, 2009-10 FISCAL YEAR (MILLIONS)

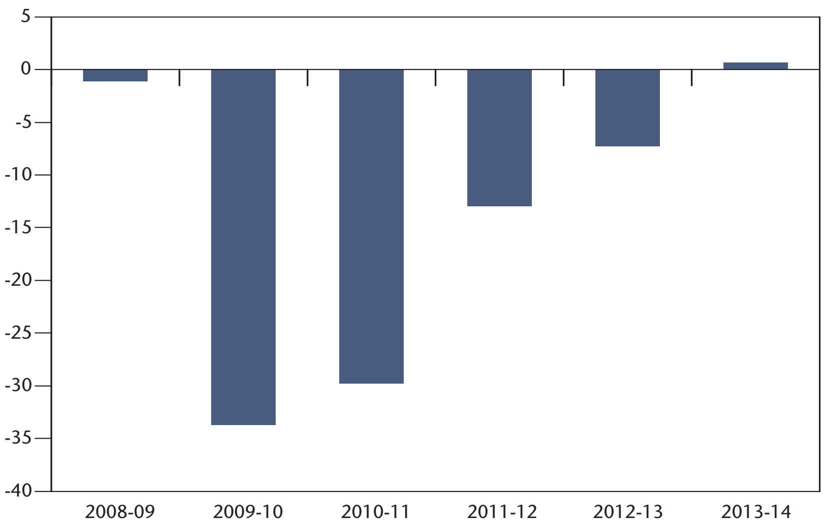


Source: Budget 2009, table 3.9.
Note: Saskatchewan, Alberta and British Columbia will not receive Equalization payments in 2009-10.

Department will be dusting off old briefing notes warning governments about what happens when the federal government commits to increase transfer payments by specific amounts into the future without considering what happens during an economic downturn when federal revenues are shrinking.

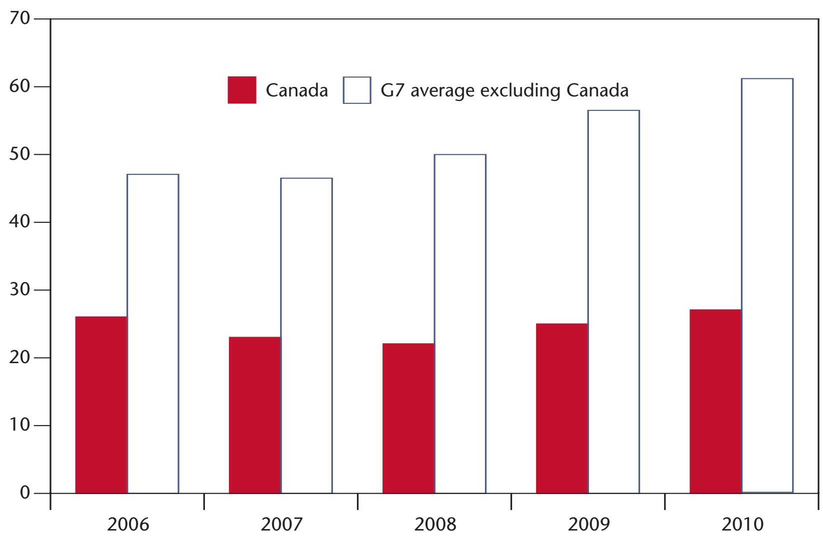
The fact that federal transfers to the provinces now stand at $49.1 billion per year and are projected to increase at more than 5 percent a year, even during a recession, raises two interesting questions. In the future will the federal government insist that the rate of increase in transfers be tied to growth in the economy? Will some future federal government seeking to balance the budget impose unilateral cuts to transfer payments, as was done in the 1990s? Or to put the question another way, if we have several years of deficits, will it be possible to balance the budget without cutting transfers since they have become such a significant part of federal spending?

FIGURE 4. FORECAST FEDERAL BUDGETARY BALANCE, FISCAL YEARS 2008-09 TO 2013-14 (BILLIONS OF DOLLARS)



Source: Budget 2009, table 4.3.

FIGURE 5. NET DEBT-TO-GDP RATIOS, 2006-10, ALL LEVELS OF GOVERNMENT (PERCENT OF GDP)



Source: Budget 2009, chart 1.1, based on OECD, *Economic Outlook*, no. 84.

Measures to balance the budget by 2013-14 are part of the budget's fiscal plan. The fiscal plan is based on cautious economic and fiscal assumptions, especially for 2009-10 and 2010-11. The average private forecast for nominal GDP growth in 2009 is -1.2 percent. The planning assumption in the budget is that nominal GDP growth in 2009 will be -2.7 percent. The budget effectively reinstates the contingency fund created by former finance minister Paul Martin and cancelled by the current government. In 2009-10 and 2010-11 the budget reduces what otherwise would be the anticipated balance by $4.5 billion, with a reduction of $3 billion in 2011-12, $1.5 billion in 2012-13 and $0.8 billion in 2013-14. Because of the economic uncertainties and the wide variations in the private sector forecasts it is prudent to err on the side of caution for the first two years. The outstanding question is: Are there reasons to be more certain and less cautious for the period after 2011?

The budget also follows the example of provinces like Saskatchewan in the 1990s by laying out a five-year fiscal plan whereby the deficit is reduced from $34 billion in 2009-10 to $30 billion in 2010-11, to $13 billion in 2011-12, to $7.3 billion in 2012-13 and to a surplus by 2013-14 (figure 4). Experience from the 1990s shows that, if used properly, a fiscal plan with specific targets can help the government impose spending discipline on its own members and on free-spending opposition parties. Whether these targets are achievable depends on many variables: Will the economy recover in 2010, will new spending decline as projected from $18 billion in 2009-10 to less than $5 billion in 2011-12, and will the government be able to live up to its commitment to sell assets and reduce other forms of government spending?

There has been much debate about whether the budget will provide the amount of stimulus to the economy that its projections show. The debate is interesting but somewhat academic. What we all know, and this is the bad news part of the budget, is that whether the economy rebounds by 2010 will depend less on this budget and more on what happens in the United States, China, India and other parts of the globe. Today what everyone agrees on is that things will get worse before they get better.

The good news of the budget is that when recovery does come, Canada will be in much better shape than any other major developed country. Even after all of the new spending, Canada's debt-to-GDP ratio in 2010 will be less than half of the average of the other G7 countries (figure 5).

Only time will tell whether the budget will be timely, whether major projects are up and running within months, not years. Most of the spending and tax measures are targeted to boost economic activity and create jobs. However, the greatest strength of this budget is its focus on infrastructure, which means most of the spending can be temporary and not add to Canada's long term deficit.

Budget 2009 is a short-term solution to what the government assumes will be a short-term, two-year problem. Critics who lament the fact that the budget lacks long-term vision should consider the following. The current Canadian economy is like a patient on an operating table after a heart attack. The task at hand is to stabilize the patient and help with recovery. Whether the patient is eating the right food or exercising enough is a question for the future.

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IRPP Board Chair Janice MacKinnon is a professor of public policy at the University of Saskatchewan. Author of Minding the Public Purse, *she was finance minister during the fiscal crisis of the 1990s when Saskatchewan became the first Canadian province to balance its budget.*