

Intelligence MEMOS



From: Don Drummond
To: The Office of the Prime Minister
Date: August 24, 2020
Re: **DON'T FORGET A FISCAL ANCHOR FOR THE SPEECH FROM THE THRONE**

Prime Minister Trudeau has indicated the government will disclose expensive initiatives to Canadians in a Speech from the Throne on September 23.

Without also proposing very large tax increases, this new agenda would clearly abandon any return to the fiscal anchors of the last two Liberal election platforms, respectively to balance the budget by 2019 and gradually reduce the debt-to-GDP ratio toward 30 percent.

While Canadians support the extraordinary measures taken to address COVID-19, they have not been given the opportunity to discuss, much less give the government a mandate to permanently veer off that fiscal course. The government has an obligation to give people the information necessary for a national discussion about the country's economic and fiscal future and set out the choices for the future.

One choice is to re-establish a fiscal anchor. Without one, Canada could wind up in a fiscal crisis as occurred in the mid-1990s when the debt-to-GDP ratio crested at 66.8 percent, after which great sacrifice was required to make the fiscal situation sustainable. There is no great magic in the pre-pandemic 30-percent debt ratio, but it had the desirable features of establishing a rough sense of intergenerational equity, keeping interest payments down so the bulk of tax revenues could finance the services Canadians want, and providing flexibility to respond to future shocks, like the appearance of COVID-19.

It would not be easy to return to that ratio any time soon. Assuming 3.5-percent average annual growth in nominal GDP from the 2019 base and a deficit of \$100 billion for 2021-22, down sharply from the estimate of \$343.2 billion for this year, it would require nine years of average surpluses of \$16.7 billion to hit a 30 percent debt ratio by 2030-31. Merely balanced budgets would lower that ratio to 34.5 percent.

Considerable pressures work against such scenarios. As the Public Health Agency of Canada has warned, the virus could linger for several years, preventing the economy from recovering fully and making it difficult to phase out pandemic rescue measures. Moderate productivity growth and pandemic-related hits to investment, immigration and the matching of labour demand and supply could depress Canada's growth rate for many years. Interest rates will go up eventually; a one-percentage point increase in the effective interest rate paid on federal government debt would add \$10 billion per year to the deficit. The federal government is unlikely to be able to withstand the policy and political pressure of its lessening share of healthcare costs under the Canada Health Act, especially given population aging.

The largest pressure may well be the initiatives the government is considering for the Speech from the Throne. A Guaranteed Basic Income has been estimated by the Parliamentary Budget Office (PBO) to cost \$47.5 to \$98.1 billion for just six months. The PBO put the price tag on a National Pharmacare Plan at \$22.6 billion per year. A National Childcare Program could easily double the \$7 billion over 10 years the Liberals gave to the provinces in the 2017 Budget.

If a fiscal stimulus plan becomes necessary to strengthen economic recovery, 1 percent of GDP (\$20 billion) would be the minimum table stakes. Estimates of Canada's current infrastructure vary wildly from \$50 and \$570 billion. Green initiatives could add billions to spending or reduce revenues. The Assembly of First Nations estimates that more than \$10 billion more needs to be spent annually to address the poor living conditions. To the extent such initiatives raise economic growth, there would be an offset through higher revenues, but it would be partial.

Canadians may have been shocked that the debt burden will rise to 49.1 percent of GDP this year. They now need to realize that it could remain at that elevated level under the sort of agenda being hinted for September's Speech from the Throne.

That result would flow if deficits after 2021-22 flattened to around \$50 billion because a portion of the initiatives listed above were implemented without significant tax increases.

Going further and allowing the deficit to persist around \$100 billion would drive the debt burden back close to the 1995-96 crisis mark within 10 years; the sacrifice would be paid by today's children and grandchildren.

Alternatively, taxes could be raised to pay for new initiatives but the choices there are tough given Canadians already pay high taxes and the essential need for Canada to be competitive in the global economy.

The economic and fiscal future of Canada has perhaps never been more uncertain. That is not a good context from which to spring a Speech from the Throne launching the country in a new and risky direction. Canadians need to understand the risks and the choices they face and be given the required information to have an informed national discussion of our country's economic and fiscal future.

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