

The World Economy: Implications for Canada's Fiscal Policy



Jack M. Mintz, Palmer Chair in Public Policy
School of Public Policy, University of Calgary

This is a presentation of Canadian Federation for the Humanities and social sciences, in its Big Thinking lecture series, made on the November 17, 2011.

Check against delivery.

Having just returned from long trips to Israel and Australia in this past month, it is good to see that some countries continue to enjoy low unemployment, good growth and, in the case of Australia, a superb balance sheet. Even so, many experts in these vibrant economies keep a close eye on world developments for potential risk that could hurt their economies.

Canada is also in relatively good economic shape with somewhat plodding growth, an improved employment picture, low inflation and a strong balance sheet. Our main risks are global; especially emanating from Europe and the United States. Unlike Australia, which benefits from expanding Asian markets, we have the economic and fiscally challenged United States as our major trading partner. So, many Canadians are prudently asking how Canada's fiscal policy should react to the current world order.

I will attempt an answer to this question with a "base" forecast of world growth. Recent IMF forecasts have downgraded growth as a result of economic slowdowns in the advanced countries. The U.S. is not expected to grow much more than 1.8% in 2012. The European Union could have even worse growth at 1.1%. Japan should see 2.3% growth. The average of these countries (which taken together represent fully one half of world GDP) would be about 1.4%. The rest of world, made up of the other advanced, emerging and developed economies, is expected to grow next year at 5.6%, resulting in overall world economic growth of 4.0%. Thus, world growth for 2012 is sub-par in a historical sense, but is not a recession.

The Canadian economy is expected to grow next year at roughly 2.8%, somewhat below its historical average but better than the United States. It should be noted that given the risks facing the world economy, this forecast is less than dependable.

The most serious current global risk is the potential of another banking crisis in Europe arising from the sovereign debt defaults. Current interest rate spreads of sovereign debt of the PIIGS (Portugal, Ireland, Italy, Greece and Spain) relative to Germany predict as high as 100 percent chance of default in Greece to an estimate of

a 30 percent default risk by Spain. These extraordinarily high expected default rates reflect large net-debt burdens ranging from 190% in Greece to 60% in Spain by 2013.

Europe also faces the so-called “contagion effect” wherein a default or “haircut” by one country, like Greece, would lead to eventual defaults in the other PIIGS who would have difficulty selling sovereign debt. Such defaults would be severe for European banks that hold sovereign debt to satisfy their existing capital requirements. Belgian banks are most exposed with PIIGS debt accounting for over 60% of their tier 1 capital. Germany and Japan (about 55%), France (40%) and Swiss banks (20%) would be heavily affected. US banks at 7% are much less exposed. While banks can reduce sovereign debt risk with credit default swaps, the potential losses become less known if banking stress should happen. As we saw this summer, US banks quit lending to European banks due to counter-party risk.

European efforts to contain potential sovereign debt risks will be critical in the coming months. The policy most needed is for the European Central Bank, or the European Union countries, to backstop banks facing sovereign debt defaults or “haircuts”, to maintain confidence in the European markets. That, however, will require significant political will and action. And that makes markets nervous as each bit of political news in Europe causes large market swings.

The other potential risk is a severe contraction in the United States arising from a loss in confidence in the US dollar. Although I do not expect this outcome to occur, I do believe that the US will require significant fiscal restructuring. That restructuring will, in turn, work through the US economy with some deleterious results. The current US debt burden has not yet stabilized. In 2007, US net debt as a share of GDP was 40%. It is to rise by 2013 to 75% and 80% by 2016. Such high debt ratios, exceeding Canada’s worse position in 1996, have inevitable consequences with large debt placements and high fiscal budgetary costs.

To date, the US has been incapable in putting together a fiscal plan to deal with the twin problems of poor growth and stabilizing its large debt burden. It is not easy to do so with a lack of political consensus. One side resists tax increases that will surely be needed to help close the gap. The other seems focused on redistribution rather than economic growth. A political coming together will be needed, but does not appear to be imminent.

Current plans to introduce long term tax increases on incomes, capital gains and dividends with temporary payroll and business tax reductions will not succeed in generating growth. Temporary tax reductions simply shift decisions from the future to the present, and raising tax rates will not address long-term systemic problems in the US economy. The US needs an approach more similar to the United Kingdom that has introduced reforms to improve economic growth, curtailed spending and raised taxes - especially consumption taxes.

Hopefully, the Congress's Supercommittee will provide recommendations on November 23rd that will reduce debt burdens while putting the US on a growth path.

Since we do not yet know how European and US risks will be mitigated, it would be best at this time to stay the course in Canada. Governments should look to balance the books in the medium term with either sharp increases in taxes or large spending cuts. Canada should not take on another economic stimulus. If there is a major downturn in the world economy, the federal government has a strong enough balance sheet that it could react with spending and tax policies to stimulate the economy if needed. But it would be foolish to do so unless there was a severe global contraction, which is only a possibility and not a reality.

Even adopting a 'stay the course' approach, there are steps that the federal government could take in upcoming budgets to put Canada's economy on a better growth path.

Here are three priorities that should be a basis for growth-enhancing reforms:

Focus on spending priorities that encourage growth: Governments invest in three important areas that add to the productive capacity of governments: education, research and infrastructure. Currently, Canada's business research and development still lags. It is not that we are unable to discover new ideas and put them to market. Resource exploration and development expenditures – over twice the level of research and development – have led to major discoveries of wealth that are being brought to the market. We have had major innovation successes, like Blackberry and various medicines. However, Canada needs more discovery and commercialization.

Infrastructure spending announced in the latest Economic Statement for federal trade priorities is an important step to improve access to international markets. Research should be focused on a global competitive strategy, rather than spread out in small doses across a number of regions. Federal procurement policies could be focused on enhancing research capacity in Canada as is the case in the United States.

Reforming public programs and regulations: In recent years, Canada has successfully reformed many of its spending programs such as employment insurance, Canada Pension Plan and social assistance. However, more can be done to ensure that programs are effective and delivered at the lowest cost possible.

Certainly, business subsidies, including green subsidies, should be reviewed in terms of their effectiveness. With lower corporate taxes, these subsidies are less important. Of special note are regulations that impose lengthy delays for investment and job creation. The ability to build infrastructure, transportation networks, power plants, pipelines and buildings is being seriously compromised when they face lengthy assessments, sometimes up to 10 years long. These delays are a de facto "tax" on many projects.

Of all the programs, continuing reforms are most needed in health care, which is the most important provincial expenditure today. Health care is a difficult issue since its effectiveness depends not just on dollars spent but also on administration. I come from a province that spends the most per capita on health care but has mediocre results compared to other provinces. Clearly, there is room for improving the system that would result in reduced waiting times for all procedures (not just selected ones) without compromising the principle of universality and the protection of those least well off. There is no question that we can consider provincial experimentation with a variety of approaches to improve effectiveness without undermining the principle of making sure all Canadians have access to good quality health care.

Tax reforms: The days of fiscal surpluses and tax reductions have come to a halt. However, our tax system is becoming riddled with special tax preferences and narrow bases. Lower tax rates could be achieved by lower tax rates, while ending special preferences.

Recent concerns have been expressed about inequality and the need to raise taxes on the rich “1 percent”. How much redistribution should occur in the tax system is a political debate, and it is important to remember that the current Canadian tax and expenditure system already results in significant redistribution. Indeed, once taking into account both taxes and transfers, income inequality has changed only slightly in the past 30 years, and governments today are redistributing more than ever (as demonstrated by the difference in pre and post tax inequality measures). Whether this redistribution is enough or too little, we must remember that too much redistribution could compromise economic growth. Even for those less fortunate, growth is critical to provide jobs and taxes to support social programs.

The aim of the tax reform should be to reduce its economic cost and encourage growth. Changing the mix of taxes as well as reducing rates and broadening each tax base can achieve this objective.

A strategy pursued by most countries has been to shift taxes away from investment and savings, to consumption. This has been achieved with personal tax reforms that have reduced taxes on capital income or by greater reliance on sales taxes, especially the Value Added Tax. In Canada, we have done both: we have broadened limits for pension and RRSP savings, introduced the Tax Free Saving Account and reformed sales taxes by replacing single-stage taxes with the GST and HST. Sales taxes as a share of GDP have not changed in the past 20 years although we are now seeing the HST provinces begin to raise their rates, which in my mind, is the appropriate level of government to assign the tax. The GST, however, requires an overhaul. Its base and structure has not changed since its inception twenty years ago. Now, with GST/HST rates approaching 15 percent, current distortions in the GST/HST base matter more.

Finally, with the challenging international economic environment, now may in fact be the right time for the federal government to introduce another tax reform. The Technical Committee on Business Taxation report in 1997 led to many good business tax reforms in later years. A new study could focus on personal taxes on incomes, payroll and consumption, all with the goal of making Canada a more competitive country in a troubled international time.