

UNDERSTANDING THE NATURE OF CANADA'S FISCAL AND ECONOMIC CHALLENGES

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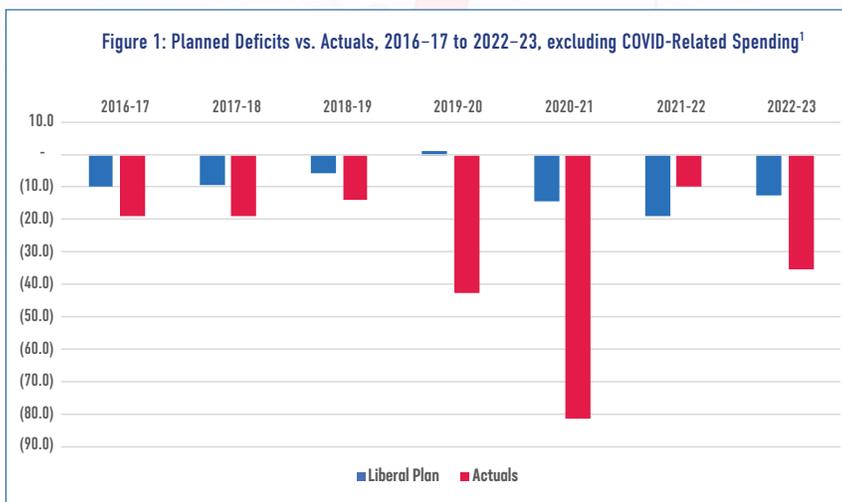
The Trudeau government was first elected in 2015 based in part on a new approach to government policy, which promised greater prosperity for Canadians based on short-term deficit spending (totaling \$25.1 billion over three years), lower taxes for most Canadians (except higher-income earners), and a more active approach to economic development (LPC, 2015). This new policy direction stood in stark contrast to the consensus of the previous 20 years (Clemens and Palacios, 2017). The result has been a marked deterioration in the country's finances, economic stagnation, and a collapse in business investment. If Canada is to restore its fiscal and economic health, Ottawa must enact fundamental policy reform.

Government spending, taxes, and debt

The Trudeau government has markedly increased spending to finance both new programs and increases in existing programs. Federal spending (excluding interest costs) increased from \$256.3 billion in 2014-15 (the year before the Trudeau government took office) to \$448.2 billion in 2022-23 (an increase of 74.9 percent) (Canada, 2023a) and a projected \$453.0 billion in 2023-24 (Canada, 2023b). Not surprisingly, COVID-related spending contributed to increases in 2019-20 to 2021-22. But in 2022-23 and thereafter, there is no COVID-related spending.

The federal government has used tax increases and large increases in borrowing to finance these spending increases. In 2016, the federal government increased the top personal income tax rate imposed on entrepreneurs, professionals, and business owners from 29 percent to 33 percent. Consequently, the combined top personal income tax rate (federal and provincial) now exceeds 50 percent in eight provinces (with the remaining provinces only slightly below 50 percent) and in 2022 Canada had the 5th highest tax rate out of 38 OECD countries. This represents a serious competitive challenge for Canada's ability to attract and retain entrepreneurs, investors, skilled professionals, and businesses.

And while the Trudeau government reduced the middle personal income tax rate, it also eliminated several tax credits. The combination of the two policy changes means that 86 percent of middle-income families now pay higher personal income taxes (Palacios et al., 2022). If the analysis also includes increases to the Canada Pension Plan contribution rate, almost all Canadians now pay higher taxes.



The Trudeau government also borrowed to finance its new spending. Figure 1 contrasts the originally planned deficits with the actual deficits incurred by the Trudeau government (excluding COVID-related spending) from 2016-17 to 2022-23. The actual borrowing exceeds the originally planned borrowing every year (except 2021-22), often by significant margins, due to the government's inability to control spending growth.

The string of deficits means federal debt (measured as gross debt) has ballooned to \$1.9 trillion (2022-23) and is projected to reach \$2.4 trillion by 2027/28, fueling a dramatic growth in interest costs, which have grown by 53.2 percent (inflation-adjusted) between 2014/15 and 2023/24 and will reach

a projected \$46.5 billion in 2023/24. Interest costs now consume substantial revenue that is then unavailable for government services or tax reduction.

Simply put, Trudeau government policy changes have produced large increases in government spending, taxes, and borrowing. Unfortunately, these policy changes have not resulted in a more robust and vibrant economy.

Weak economic growth and collapsing business investment

The broadest measure of living standards is GDP per person, which calculates the total value of all goods and services produced in the economy in a given year (adjusted by the population). As illustrated in Figure 2, between 2016 and 2019 (pre-COVID), growth in per-person GDP (inflation-adjusted) was an anemic 0.9 percent. According to one study, among the last five pre-recession periods in Canadian history, the Trudeau period (again, 2016 to 2019) recorded the weakest economic growth (Clemens, Palacios, and Veldhuis, 2021). Another study found that Canada's per-person GDP growth from 2013 to 2022 was the weakest on record since the 1930s (Cross, 2023). And per-person GDP in 2022 (inflation-adjusted) had still not recovered from the pandemic losses and was basically stagnant at 2018 levels (see figure 2).

Prospects for the future, given current policies, are not encouraging. The OECD projects that Canada will record the lowest rate of per-person GDP growth among 32 advanced economies from 2020 to 2030 and from 2030 to 2060 (OECD, 2021). Countries such as Estonia, South Korea, and New Zealand are expected to vault past Canada and achieve higher living standards by 2060.

According to a recent analysis, Canada's economic growth crisis is due in part to the decline in business investment, which is critical to increasing living standards because it equips workers with tools and technologies to produce

more higher-quality goods and services. This, in turn, fuels innovation and improved productivity (Cross, 2023). There are obvious explanations for the decline in business investment including regulatory barriers, particularly related to the energy and mining sectors (Globerman and Emes, 2021), and government deficits, which imply tax increases in the future, dampening investment today. Business investment (inflation-adjusted), excluding residential construction, has declined by 1.8 percent annually since 2014.

According to a 2023 study (Hill and Emes, 2023), between 2014 and 2021, business investment per worker (inflation-adjusted, excluding residential construction) decreased by

\$3,676 (to \$14,687) compared to growth of \$3,418 (to \$26,751) in the United States. Put differently, in 2014, Canadian businesses invested 79 cents per worker for every dollar invested in the United States. By 2021, that level of investment had declined to just 55 cents per worker.

Moreover, the amount of investment in Canada by foreigners has decreased while the amount of investment by Canadians outside of the country has increased. In 2008, the two levels were roughly comparable—\$65.7 billion in foreign direct investment (FDI) in Canada vs. \$84.6 billion in investment by Canadians outside of the country. However, a sizeable change began in 2015; by 2022, the amount of FDI (\$64.6 billion) was significantly smaller than the amount of investment by Canadians outside the country (\$102.3 billion).

Finally, while Canada's labour market has consistently demonstrated its strength and resilience, the labour market numbers hide some concerning trends. For example, between February 2020 (when the pandemic began) and June 2023, private-sector job creation (net) was fairly weak at 3.3 percent compared to 11.8 percent job growth in the government sector (Eisen, Ryan and Palacios, 2023). In other words, the recovery and growth in the private sector following the pandemic has not been as strong as expected.

Conclusion: The Path Forward

There is reason for optimism, however, since many of Canada's challenges are of the federal government's own making. The Chrétien Liberals in the 1990s faced many of the same challenges that we do today (Veldhuis, Clemens, and Palacios, 2011). By shifting the focus to more prudent government spending, balanced budgets, debt reduction, and competitive tax rates, the Chrétien Liberals—followed in large measure by the Harper Tories—paved the way for two decades of prosperity when Canada outperformed other OECD countries on economic growth, job-creation, and business investment.

To help foster greater prosperity for Canadians today, the federal government can learn from the Chrétien Liberals, and the Harper Tories. The rest of this series identifies policy options that can increase living standards for Canadians by repairing federal finances, improving tax competitiveness, and lowering economic barriers. These reforms could help build a more prosperous country through the creation of good jobs which would lead to rising incomes for Canadians. ■

