



Executive Action

March 2010

Lessons From the Recession and Financial Crisis

Lesson 5—Sound Fiscal Policy Is Key to Keeping the Economy Afloat in Hard Times

At a Glance

- ◆ An intelligently designed fiscal system is more than a tool for generating revenue that governments then spend—it plays a vital role in shaping a country's economic performance.
- ◆ Tax reform is only one part of the fiscal puzzle.
- ◆ Of all the fiscal stimulus measures, infrastructure spending has the largest impact on economic growth.
- ◆ Automatic stabilizers are a crucial fiscal buffer in times of economic downturn.

The 11 years prior to the 2008–09 recession were boom years for Canada's federal government. Year in and year out, the government enjoyed stronger-than-expected revenue growth and large fiscal surpluses that almost always surprised on the upside. But even as it reaped the benefits, the federal government still found itself having to make difficult choices. Everyone, it seemed, wanted a piece of the pie—and the pie was sliced up and handed out. Personal and corporate taxes were cut, transfers to the provinces and territories were made more generous, and federal programs were expanded. In general, however, the federal policy measures implemented over the past 10 years have helped boost Canada's long-term economic growth prospects.

The provinces, too, reaped the benefits of growing own-source revenues, as well as generous growth in federal transfers (although the capacity of the provinces to implement productivity-enhancing policies was weakened by their need to meet the ever-rising demand for health care).

The Context for This Series

In 2009, the global economy experienced its first decline in aggregate output in over five decades, driven by events in the U.S. housing and credit markets that rippled across the globe. Fortunately, governments in many countries quickly intervened by shoring up failing financial markets and stimulating demand. There is now strong evidence that the recession has come to an end, although as discussed in the Conference Board's various economic outlook products, this recovery is not likely to be as strong as those that followed previous recessions.

At this point in the recovery, what lessons can be learned from the financial crisis and resulting recession and the policy response of governments? The Conference Board of Canada's Forecasting and Analysis team has examined the developments of the past year. We have drawn key lessons for the world and for Canada that deserve priority discussion among policy makers and business leaders.

Other executive action briefings in this series:

Overview—What Caused the 2008–09 Financial Crisis and Recession? (January 2010), *Lesson 1—The Financial Sector Is Weak and Needs New Standards* (January 2010), *Lesson 2—Public Sector Financial Institutions Prove Their Worth* (January 2010), *Lesson 3—Recession Only Delayed the Inevitable Workforce Shortages* (February 2010), *Lesson 4—"Too Big to Fail" Means Too Big* (February 2010).

Then the recession struck. And early in 2009, federal and provincial governments implemented recession-fighting measures, including tax cuts, various credits, and a wide range of spending programs. How well have these measures worked?

THE RIGHT FISCAL SYSTEM CAN HELP GOVERNMENTS WITHSTAND RECESSION SHOCKS

An intelligently designed fiscal system is more than a tool for generating revenue that governments then spend—it plays a vital role in shaping a country's economic performance, productivity, international competitiveness, and sustainability for future generations. The way in which fiscal policies—taxation and spending—are framed determines the relative emphasis that businesses and citizens place on investment versus savings, and on work versus leisure. Moreover, a sound fiscal framework can play a

vital role in supporting strong economic performance, not only in the good times, but also when recession hits. Ironically, the after-effects of a recession provide a climate that is ripe for fiscal reform. However, so far, few countries have moved to seize the opportunity by implementing sound policies aimed at long-term fiscal sustainability.

Economic research provides a valuable guide to the relative priority of various tax policies. In good economic times, such policies are aimed at boosting productivity, and in times of economic downturn, they are effective in inoculating an economy against recessionary shock or helping in its recovery. For example, Table 1 provides the results of recent research by the Federal Department of Finance, using what is called a general equilibrium model¹ to test the long-term impact of different tax cuts on households and the level of economic output.

A sound fiscal framework can play a vital role in supporting a strong economic performance when a recession hits.

The research shows that targeted tax cuts that support investment by businesses and by individuals provide, by far, the largest payback in terms of increased productivity, output, and welfare. Furthermore, cuts to personal and corporate income taxes provide a boost to productivity and economic growth that is significantly larger than cuts to consumption taxes. The results of this research by the federal Department of Finance are consistent with the general body of economic literature and research on tax reform, both for Canada and for other nations.

1 Researchers at the Department of Finance developed a general equilibrium (GE) model to estimate the impact of various policy measures on welfare. The GE model offered a full accounting of how businesses, households, and government might be affected by various policy shocks, based on theoretical economic relationships. GE models are generally good at identifying the long-term equilibrium (i.e., when there is no excess demand or supply in any market) consequences of different policy measures. In Table 1, the welfare gain is defined as the ratio of the net gain to households versus the loss in the present value of government revenues due to the tax change. The second column displays the long-term impact on GDP relative to a 1 per cent of GDP change in the revenues from the tax. The amount of tax cut is calculated ex ante (previous to running the model) because government revenues are affected by the shock itself.

Table 1
Impact of Various Tax Initiatives

Tax measure	Welfare gain (\$) per dollar of lost present value in government revenue	Percentage change in steady state GDP for an ex ante 1 per cent of GDP reduction in government revenue
Increase in capital cost allowances on new capital	–	4.39
A cut in personal capital income taxes	1.30	3.36
A cut in sales taxes on capital goods	1.29	3.05
A cut in corporate income taxes	0.37	1.94
A cut in personal income taxes	0.32	1.29
A cut in payroll taxes	0.15	0.66
A cut in consumption taxes	0.13	0.19

Source: Maximilian Baylor and Louis Beauséjour, "Taxation and Economic Efficiency: Results From a Canadian CGE Model." Federal Department of Finance Working Paper 2004-10 (Ottawa: Department of Finance, 2004).

But have policy makers looked at the research and acted accordingly? The answer is generally "yes"—at least, for Canada. (Elsewhere, the actions have been less encouraging.) Recent Canadian tax reform experience has, by and large, been positive, with productivity-enhancing initiatives implemented on many fronts. Canada entered the financial crisis in a very strong fiscal position relative to other developed nations. By the end of the 2007–08 fiscal year, Canadians were happily sitting atop a nearly \$10-billion annual surplus—the 11th federal fiscal surplus in as many years. Provincial fiscal balances had also strengthened considerably. Personal and corporate tax collections had been on the upswing, benefiting particularly from the commodities boom and growth in incomes for higher-income groups. The revenue growth more than supported rising federal program expenditures and transfer payments.

With ample fiscal manoeuvring room, the federal government was able to implement two successive 1 percentage point cuts to the federal goods and services tax—but at the price of reducing the potential federal fiscal surplus. This controversial move, which brought the GST rate from 7 per cent to 5 per cent, lowered annual revenues by an estimated \$10–\$12 billion. As shown in Table 1, economic theory suggests that reductions in consumption taxes have, by far, the smallest positive impact on GDP and on households. Thus, most economists agree that more effective tax reduction measures could have been implemented at the same funding cost.

That is not to say that other, more efficient, fiscal initiatives were ignored. Quite the contrary. At the federal level, the corporate income tax rate has been cut aggressively. From 21 per cent in 2008, the rate is scheduled to drop yearly until it reaches 15 per cent by January 2012—or half the level it was in 2000. Capital taxes on corporations have been eliminated at the federal level, and the provinces are following suit. Capital cost allowances (CCAs) on capital equipment have been extended to Canadian firms at a deduction level of 50 per cent through to 2011, encouraging businesses to purchase productivity-enhancing equipment at this crucial juncture in the business cycle. The plan calls for the marginal effective tax rate on capital investment to fall to 18.9 per cent by 2013—down dramatically from the nearly 29 per cent rate in 2008!

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Furthermore, tariffs on imported equipment used in production have been eliminated, some personal income tax rates have been reduced, and some sensible new tax credits (such as the working income tax credit) have been introduced. All in all, the federal government has used tax policy effectively.

At the provincial level, Canadians have also seen some well-considered tax reform measures. In response to concerns about deficits and net provincial debt, Quebec has opted to raise its sales tax (QST) by one percentage point, effective January 1, 2011. As a result, Quebec consumers will have an incentive to spend more in 2010 before the QST rate goes up. Similarly, Ontario and British Columbia have opted to harmonize their provincial sales taxes with the federal GST base under a comparable framework—a move that will generate more revenues as the economic recovery solidifies.

Health care currently absorbs about 41 per cent of total program spending among the provinces collectively.

However, tax reform is only one part of the fiscal puzzle. The Canadian fiscal policy landscape has arguably been dominated by overspending in the good times. Politicians have tended to focus on the “here and now” rather than on the country’s future economic well-being. Virtually all federal and provincial jurisdictions in Canada offered some form of consumer-based stimulus in the lead up to the financial crisis, with little thought given to the long-term fiscal sustainability of such measures. This occurred at a time when core public spending was ballooning, while the tax base was remaining fairly flat. An example of the challenges facing the provinces is health care, which currently absorbs about 41 per cent of total program spending among the provinces collectively. This “core” need is at severe risk of crowding out other program spending as the baby-boom generation ages. These are structural problems that must be addressed head-on, but that have been largely ignored so far.

As it recovers from the recession, Canada finds itself in relatively good fiscal shape in comparison with many other developed economies. Many nations—developed and developing alike—will be hard-pressed to implement productivity-enhancing tax reform while also returning to fiscal balance in a timely fashion. Canada has responded to the challenge by rebalancing its tax policies in favour of enhanced tax competitiveness going forward; the

recent federal budget for 2010–11 provided a concrete plan for getting back to fiscal balance by 2015–16. However, the “elephant in the room” remains the gap between core program spending and tax revenues.

SHORT-TERM STIMULUS TO BRIDGE THE GAP IN PRIVATE SECTOR DEMAND

Government stimulus through aggressive fiscal and monetary policy intervention is a powerful instrument for restoring economic growth, but it also has its limits. Government stimulus comes in two basic forms: monetary stimulus, through cuts to interest rates and other interventions; and fiscal stimulus, through tax cuts and new spending initiatives (which usually result in budgetary deficits that have to be addressed once economic growth returns).

The Canadian fiscal policy landscape has arguably been dominated by overspending in the good times.

Monetary authorities around the globe intervened aggressively during the winter of 2008–09 to try to stave off a prolonged recession and to address the spectre of generalized deflation (a drop in the overall price index that can create a self-perpetuating downward spiral in consumer spending). Central banks in all corners of the globe cut interest rates deeply, with the U.S. Federal Reserve Board and the Bank of Canada reducing short-term rates virtually to zero. The Fed and the Bank of Canada have signalled that rates will stay close to zero into mid-2010. The Fed (and many other central banks, but not the Bank of Canada) also resorted to “quantitative easing”—the creation of money, which is then used to buy government bonds—to further fuel the recovery by adding extra monetary stimulus to the U.S. economy.

However, the severity of the recession placed limits on monetary stimulus. Commercial banks needed to restore their own financial health before passing the full benefit of lower interest rates on to their customers, creating a drag on the effectiveness of lower interest rates.

Credit markets are now healing, but are still not back to normal. Because monetary policy works with a long lag, governments could not wait for monetary accommodation to become effective. Fiscal stimulus was therefore required as a complement to monetary action.

In an attempt to turn the tide on what threatened to be a very long and deep recession, governments around the world opened the floodgates of fiscal stimulus. The U.S. came up with a massive fiscal stimulus package and urged fellow governments of the G20 to follow suit. Even the International Monetary Fund (IMF)—traditionally the bastion of fiscal prudence—recommended that countries inject fiscal stimulus worth 2 per cent of GDP. All in all, the G20 countries have gone beyond the call of duty, introducing stimulus packages averaging 2 per cent of GDP in 2009 and 1.5 per cent in 2010. (See Table 2.)

Attempting to turn the tide on the recession, governments around the world opened the fiscal stimulus floodgates.

Not to be left on the sidelines (or risk being accused of not doing its part), the Canadian government announced a major fiscal stimulus package of its own in January 2009. The plan, designed to kick-start the economy and restore confidence, was billed as providing fiscal stimulus of 1.9 per cent of real GDP in 2009 and 1.7 per cent for 2010, in line with the G20 average.²

FOUR BROAD CATEGORIES OF FISCAL STIMULUS

Fiscal stimulus programs can largely be grouped into four broad categories: temporary tax cuts, permanent tax cuts, tax credits on the purchase of specific items, and spending on infrastructure. Each of these categories uses a wide range of specific measures, and each comes with its own set of benefits and drawbacks. (One of the most

² International Monetary Fund, *The State of Public Finances Cross-Country Fiscal Monitor: November 3, 2009*, IMF Staff Position Note SPN/09/25 (Washington, DC: Author, 2009).

Table 2
Stimulus Plans in the G20
(per cent of GDP)

	2009	2010
Argentina	1.5	0.0
Australia	2.1	1.7
Brazil	0.6	0.8
Canada	1.9	1.7
China	3.1	2.7
France	0.7	0.8
Germany	1.6	2.0
India	0.6	0.6
Indonesia	1.3	0.6
Italy	0.2	0.1
Japan	2.4	1.8
South Korea	3.9	1.2
Mexico	1.5	–
Russia	4.1	1.3
Spain	2.3	0.0
Saudi Arabia	3.3	3.5
South Africa	1.8	–0.6
Turkey	0.8	0.3
United Kingdom	1.4	–0.1
United States	2.0	1.8
Weighted average	2.0	1.5

Source: International Monetary Fund.

effective ways to deliver stimulus in a timely fashion is through the social safety net with its automatic stabilizers, such as Employment Insurance and social assistance. But these programs were already in place and so do not fall into the category of new, active stimulus measures.)

While there has been near-universal adoption of stimulus programs around the globe, economists remain divided about the effectiveness of active fiscal measures in reducing the damaging effects of the global recession. A key issue is timing: Will the programs support economic activity while the private sector is still weak? Or will they arrive too late and add to inflationary pressures at a time when the private sector is recovering? Aware of the

challenge, governments tried to formulate their programs in an effort to get traction from the new measures as quickly as possible. Programs included such innovations as the “cash for clunkers” program (which encouraged people to replace their older autos with new models), the home renovation tax credit, tax cuts, and spending on small and large infrastructure projects.

Temporary tax cuts can be implemented very quickly, putting cash into the hands of the private sector.

According to the IMF, about one-third of the G20’s stimulus efforts are in the form of tax cuts, and some of these tax cuts are temporary in nature. In the United States, half of the 2009 stimulus is in the form of tax cuts to individuals and corporations; in 2010, this percentage will rise to 80 per cent.

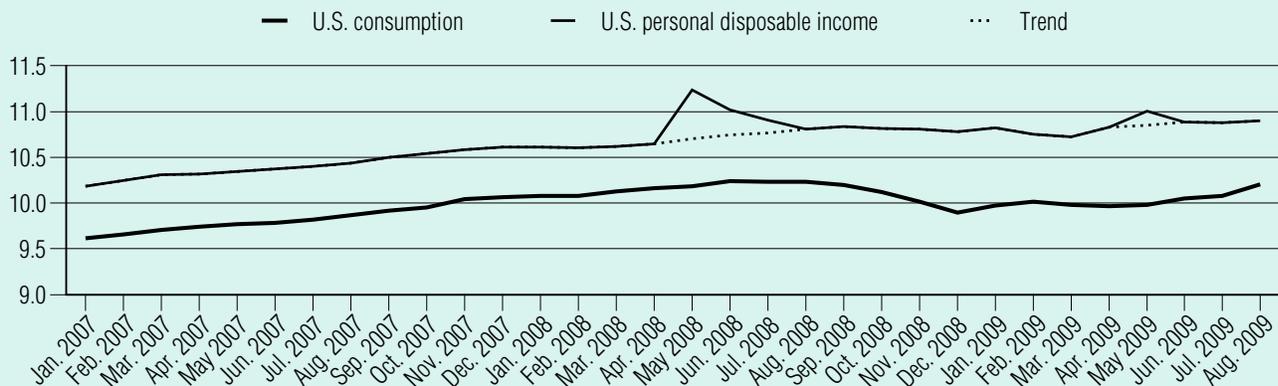
Temporary tax cuts can be implemented very quickly, putting cash into the hands of the private sector, be it households or businesses. However, during an economic crisis, the extra funds might be saved rather than spent, especially if the measures are known to be temporary. Recent U.S. evidence suggests that temporary tax cuts had little success in lifting consumer spending. Most of

the \$100 billion in tax rebates sent to households in early 2008, and credits handed out again in 2009, ended up being added to household savings rather than spending. (See Chart 1.)

Funds flowing to households from permanent tax measures are more likely to be spent. However, permanent tax cuts also result in a permanent loss in government revenues. Inevitably, spending cuts are needed in order to rebalance the budget once the economy recovers. In addition to the uneven impact between permanent and temporary tax cuts, tax measures are also plagued by significant economic leakages. Canada, in particular, is a highly open economy that is deeply integrated into the North American production chain. International trade represents about 40 per cent of Canada’s GDP (unlike in the United States, where international trade accounts for just 13 per cent of GDP). As such, about 40 per cent of the impact of every dollar handed back to consumers in Canada via tax cuts will “leak” out of the Canadian economy through increased imports.

Tax credits applied to specific items, such as vehicles or homes, have proven effective through this downturn. The U.S. cash-for-clunkers program was surprisingly effective at lifting vehicle sales in July and August last year. And an \$8,000 tax credit for first-time homebuyers in the

Chart 1
Temporary Tax Reductions Have Limited Effect on Consumption
(\$ trillions, seasonally adjusted, annualized)



Source: U.S. Bureau of Economic Analysis.

United States is credited with lifting sales (although many potential buyers appear to have waited until the very last minute to take advantage of the program, which expired at the end of November 2009). Similar, but much less generous, programs were adopted by the Canadian government in the January 2009 budget. Not surprisingly, the impacts of these measures (for example, a \$750 tax credit for first-time homebuyers) are much lighter than what we have seen in the United States.

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Overall, this type of stimulus has proven to be effective and timely, especially if the incentives are large. However, the measures are biased to specific goods or industries, and they can also suffer from significant leakages. A cash-for-clunkers program in Canada, for example, would have bolstered auto imports and produced only a muted impact on the Canadian economy.

The leakages from new infrastructure spending are usually much smaller, depending on the type of project. When completed, infrastructure projects can add to economic output, lower business costs, reduce commute times, and bolster productivity. The problem with infrastructure projects is that they usually take a long time to get started and often require long construction times. Moreover, infrastructure spending will benefit certain sectors, such as construction, more than others. Policy makers are challenged to balance their choices between quick (yet leaky) tax cuts and slow (but effective) infrastructure spending.

SPECIFIC MEASURES UNDERTAKEN IN CANADA

Like many other governments, the Canadian government has resorted to a wide array of measures in an effort to spread the risks and benefits of stimulus spending. There are often unintended consequences to policy decisions, and it is prudent for governments not to place all of their eggs in one basket. In Canada, the federal stimulus plan

came later than did stimulus plans in other G20 nations and was more heavily weighted to infrastructure spending. The federal government promised to increase funding for infrastructure by almost \$12 billion, with funds allotted to four key priorities: provincial, territorial, and municipal infrastructure; First Nations infrastructure; knowledge infrastructure (to modernize universities and colleges); and federal infrastructure. The increase in infrastructure spending is expected to be matched by \$8.9 billion in provincial contributions, bringing the total stimulus from new infrastructure spending to \$20.7 billion over the 2009–10 and 2010–11 fiscal years.

Not surprisingly, the increase in Canadian infrastructure spending has been difficult to coordinate. Spending is not expected to peak until 2010, at which point the economic recovery will already be under way. Nevertheless, because private investment in structures is expected to remain very weak this year, the federal stimulus program will still be timely, helping to bridge the gap until a recovery in private sector investment is more firmly entrenched.

The leakages from new infrastructure spending are usually much smaller, depending on the type of project.

TAX MEASURES

On the tax side, the Canadian government’s personal and corporate tax cuts were timely but modest. And due to leakages through savings and imports, they will do little to shore up economic growth. Furthermore, at the same time that they are moving forward with their massive fiscal stimulus efforts, the federal government and the provinces are being more prudent when it comes to spending on existing programs. Furthermore, almost half of total government spending³ in the economy accrues to public sector wages. Recent clawbacks in wage growth will offset some of the stimulus plan. In 2009, overall real government spending in the economy, including infrastructure, increased by 3.0 per cent over 2008 levels. By comparison, in 2008, real government spending grew by 3.7 per cent. Excluding infrastructure, total real government spending on goods and services

3 Excluding transfers and debt financing.

by all levels of government posted growth of just 3 per cent in 2009—the slowest rate of growth in three years. In particular, the federal government managed to hold real spending increases to just 2.2 per cent in 2009 following a 5.8 per cent increase in 2008. Therefore, even after accounting for capital spending, total government spending grew by a slightly slower 4.5 per cent in 2009 compared with the 4.8 per cent growth seen in 2008. As infrastructure spending ramps up, total government spending is expected to expand by 5.7 per cent this year.

INFRASTRUCTURE MEASURES

Of all the fiscal stimulus measures, infrastructure spending has the largest impact on economic growth. In fact, the Conference Board estimates that in an economy performing below potential, every dollar spent on infrastructure serves to increase Canada's real GDP by as much \$1.20.⁴ Critics suggest that delays in implementation mean spending usually occurs when the economy starts to recover, and it can crowd out private investment through higher interest rates and higher business construction prices. But in the current business cycle, Canada's stimulus will still be timely—even if peak spending on infrastructure occurs in 2010.

Of all the fiscal stimulus measures, infrastructure spending has the largest impact on economic growth.

Increases in infrastructure spending began showing up in the second quarter of 2009. Nevertheless, significant slack has built up in the economy, and it will take years to work off. According to Conference Board estimates, a 5 per cent output gap (the difference between actual and potential output) was created by the recession in 2009. Structural problems, especially those affecting Canada's southern neighbour, will prevent the output gap from closing until late in 2013. Furthermore, business investment is estimated to have dropped by over

4 The economic multiplier is defined as the ratio of the total economic impact from a particular investment or fiscal stimulative measure to the initial value of that investment or measure. In this case, the multiplier is greater than unity, which suggests that the overall impact on GDP will be larger than the value of the spending on infrastructure.

\$28 billion in 2009, removing 2.1 per cent from real GDP. With corporations working to improve their balance sheets, no significant recovery in business investment is expected before 2011.

Despite its late arrival, government infrastructure spending will go a long way toward offsetting the impacts of the recession. In fact, increased infrastructure spending alone is estimated to have contributed about 0.4 per cent to overall economic growth in 2009. As the spending peaks, another 0.5 per cent will be added to real GDP growth in 2010.

ECONOMIC IMPACT ANALYSIS OF TAX MEASURES

Although the income tax measures announced in the federal Economic Action Plan in January 2009 were timelier than the infrastructure spending program, they have a smaller impact on total economic growth. The Conference Board estimates that the economic multiplier on personal income tax cuts is only 0.4 in the first year, while the corporate income tax cut multiplier is even smaller at 0.3. This means that for every dollar spent cutting taxes, real GDP is expected to increase by only 40 cents for personal income tax cuts and 30 cents for corporate income tax cuts. The multiplier on tax cuts is relatively small, as some of the impact is siphoned off through higher imports and savings. This multiplier can be increased somewhat if tax cuts are focused on low-income earners who have a higher propensity to consume.

Business investment is estimated to have dropped by over \$28 billion in 2009, removing 2.1 per cent from real GDP.

Altogether, the federal tax package aimed at households and businesses is worth about \$5.9 billion in 2009–10 and \$3.5 billion in 2010–11 on a net basis, and is scattered across a variety of different measures. On the personal side, the measures included a permanent increase in the basic personal, spousal, and eligible dependant amount; an increase in the dollar ceiling for the first two personal income tax brackets; a bump to the income levels on which the Canada Child Tax Benefit are based; and an

enhancement to the Working Income Tax Benefit. As well, the government increased the Age Credit available to Canadians 65 years of age and older, and it raised the income level at which the Age Credit is fully phased-out. On the corporate side, the government increased the level of small business income eligible for the small business tax rate, and it introduced a temporary 100 per cent capital cost allowance. Although these measures are timely, they are expected to add only marginally to real GDP growth over the next two years.

Compared with many other countries, Canada was in a strong position heading into the 2008–2009 recession.

HOME RENOVATION TAX CREDIT

In an attempt to boost residential investment, the federal government created a temporary Home Renovation Tax Credit (HRTC). The HRTC was a 15 per cent credit that applied to spending on home improvement before February 1, 2010. The credit covered eligible expenditures exceeding \$1,000 but up to a maximum of \$10,000. Many homeowners took advantage of this credit. While it is difficult to disentangle the effects of the program from other factors affecting home repairs and renovations, data for 2009 suggest that real spending on home repairs and renovations has posted a quick and significant recovery, especially when compared with the slow recovery in new home construction.

EMPLOYMENT INSURANCE: AUTOMATIC STABILIZER

Additional support for the economy came from the Employment Insurance (EI) program, which is an automatic stabilizer. On top of the basic program, the federal government announced over \$1.7 billion in enhancements to EI. These enhancements include a temporary two-year increase in the regular EI benefit entitlement periods by an additional five weeks. As well, work-sharing agreements that pay partial EI benefits to qualifying workers willing to accept a reduced workweek (and thus avoid layoffs) are extended by 14 weeks. And funding for training delivered through the EI program is increased significantly. Payments under the employment

insurance program are estimated to have risen \$5.6 billion in 2009, and they are projected to rise by a further \$1.4 billion in 2010. Overall, this is expected to add about 0.2 per cent to real GDP growth in 2009.

LESSONS LEARNED

Compared with many other countries, Canada was in a strong position heading into the 2008–09 recession. The country's banks and financial institutions were little exposed to risky sub-prime mortgages. The federal and provincial governments had generally benefited from a decade-long boom in revenues. Households and businesses were enjoying reduced tax burdens. And the Canadian real estate market was balanced (a situation that would help sustain home prices through the business cycle).

Up until 2008, government spending at both the federal and provincial levels was very strong, as governments seemingly tried to keep up with the strong growth in revenues. Times were good, and finance ministers, it could be argued, tended to neglect the importance of fiscal policy as a stabilizer to the economy.

The federal and provincial governments had generally benefited from a decade-long boom in revenues.

Provincial governments, for example, were passing bills committing themselves to maintaining balanced budgets—legislation that, in many cases, had to be quickly revised following the events of last year. Indeed, such legislation, if enforced, would have only served to worsen the effects of the recession.

The recession underlined the fact that automatic stabilizers—such as Employment Insurance and other social safety net programs—help shoulder the impact of the business cycle. They enable governments to absorb the direct hit on tax revenues that results from the drop in profits, income, and consumption during times of economic duress.

Another lesson highlighted by government efforts to deal with the economic crisis is that fiscal policy can be difficult to implement in both a timely and effective way. Tax cuts, for example, can be given out quickly, but the impact on the economy tends to be muted and short-lived. On the other hand, infrastructure spending provides a lot of “bang for the buck,” with the trade-off being that it is often difficult to implement in a timely way.

A highly accommodative monetary policy and fiscal stimulus mitigated the worst of the recession in Canada.

The 2008–09 recession was very deep and worrisome for policy makers around the globe. The call by the IMF for stimulus spending of 2 per cent of GDP was exceptional and did not go unheeded. Canada stepped up to the plate with a stimulus program comparable to that of many other G20 countries. Federal and provincial governments generally opted to devote the bulk of their economic stimulus to infrastructure spending. Even though the impact of infrastructure spending will only peak this year, it will still be timely and necessary, given the depressed state of private physical investment.

The stimulus plan helped Canada return to economic growth in the third quarter of 2009, ending a downturn that saw the Canadian economy shrink by a total of 3.2 per cent peak to trough. As recessions go, this one was less devastating than those in the recent past. The declines in output and employment, for example, were steeper during the 1991 recession, and much steeper still in the 1981–82 recession. Fiscal policy can take at least some of the credit for the turnaround, particularly by helping to close the output gap moving forward as the large fiscal stimulus package ramps up. Along with a highly accommodative monetary policy, fiscal stimulus mitigated the worst of the recession in Canada.

Key Lessons Learned

1. **Pre-recession fiscal positioning matters.** Unlike other nations, Canada’s fiscal manoeuvring room at the outset of the financial crisis was broad, thanks to a legacy of prudent fiscal management.
2. **Fiscal policy is effective, but often takes time to have an impact.** The questions of both “what” and “when” must be addressed in formulating effective policy.
3. **Not all fiscal policies are created equal.** Investment, productivity, and income-generation must be prioritized in formulating a competitive fiscal strategy.
4. **Automatic stabilizers are a crucial fiscal buffer in times of economic downturn.**
5. **Monetary and fiscal policy must be aligned.**

Acknowledgements

The Conference Board of Canada would like to thank external reviewers Sam Boutziouvis of the Canadian Council of Chief Executives, and Christopher Ragan of the federal Department of Finance and McGill University, for their comments and suggestions, which were offered in their personal capacities and do not necessarily represent the views of their organizations. Any errors of fact or interpretation are solely the responsibility of the author and The Conference Board of Canada.

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