Ottawa's new activism

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Ottawa's latest budget was greeted with yawns by many observers. That's a mistake, because Budget 2013 may ultimately mark the moment when the government signalled its readiness to embrace a more interventionist role in the economy.

Le budget fédéral 2013 a été accueilli avec un certain désabusement par de nombreux observateurs. Erreur : il pourrait bien marquer un tournant, car Ottawa y signale sa volonté de jouer un rôle plus interventionniste dans l'économie.

The 2013 federal budget was viewed by most analysts as a "stay the course" fiscal plan, with few significant spending or tax surprises. With minor fiscal adjustments on net and verbs like *extending*, *confirming* and *reallocating* scattered throughout the document, the fifth annual instalment of the Economic Action Plan produced an undeniable lack of excitement. Indeed, most analysts saw this budget as evidence that Ottawa remains content to play on the margins of policy, incrementally adjusting old approaches rather than developing new ones.

However, looks can be deceiving — often intentionally so — in the analysis of budgets. Though this budget lacked specifics on some major policy issues, it may have planted the seeds of new policy agendas that signal a more interventionist approach from Ottawa. Instead of dismissing it with a "ho-hum, nothing new here" attitude, we should read Budget 2013 like a Throne Speech — think of it as the federal government's to-do list before the next election, expected in 2015.

There is little doubt that Ottawa's primary overarching policy constraint is not so much economic as it is fiscal and ultimately political. The objective remains to balance the budget over the medium term, a goal the government hopes will be in clear view before the next election. Moreover, it is apparent that despite attempts to raise revenues, the primary policy lever to balance the budget is restraint on direct program spending by federal departments — the government estimates that this line item will account for more than three-quarters of its deficit-reducing policy actions. Transfers to other levels of government may slow down, but will not be cut in nominal terms. And taxes that voters can easily see, such as the GST or personal income tax rates, are unlikely to increase.

From a policy perspective, the exact year that budget balance is achieved is irrelevant. The unfortunate reality for the Canadian government is that international growth, particularly in the United States, the euro area and China — which is effectively beyond its control — will likely prove to be as important for Canada's economic performance and budget outcomes as any domestic policies (at least in the short term).

But make no mistake, the federal government is in reasonably good fiscal shape. Its deficit is small as a share of GDP, and, at 33 percent, the debt-to-GDP ratio is low and is expected to fall over this budget cycle. More importantly, studies by the Department of Finance and the Parliamentary Budget Office conclude that federal finances are on a sustainable track, with permanent fiscal policy room of at least 1 percent of GDP or more over the long term — after taking account of the expected fiscal impacts of Canada's aging population.

Unfortunately, the overall provincial outlook is much worse. And the larger the disparity between these two levels of government, the more pressure will rise over time for Ottawa to increase transfers or upload additional responsibilities, such as pharmacare. The

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result is that Ottawa may ultimately find itself dragged into a more activist role by the fiscal albatross of the provinces.

The three most prominent themes of Budget 2013 are skills, infrastructure and manufacturing. The first theme is clearly a worthwhile focus in the rapidly changing, globally competitive marketplace. Indeed, economic theory provides a strong rationale for government intervention, because firms tend to under-invest in general human capital — which, unlike firm-specific skills, can be transferred between jobs and makes the labour force more flexible. However, fundamental questions remain regarding the new proposal for short-term, employer-led training. Specifically, what is the true extent of skills and locational mismatch between workers and job vacancies? A key challenge, aside from securing provincial take-up (where Quebec immediately expressed its desire to opt out of any national program), will be finding a program design that does not largely subsidize training that would otherwise occur.

On infrastructure, the explicit long-term 10-year federal funding commitment is welcome — not so much because it increases funding (as it appears to essentially pre-commit to what would otherwise be the status quo), but because it extends the planning horizon while broadening the scope of admissible projects. This longer planning horizon is particularly beneficial for larger, more complex projects that are more productivity-enhancing for the economy.

Finally, manufacturing was targeted as a priority industry, after the significant job losses suffered over the past decade. This is the government's response to ongoing international competitiveness challenges related to the rise of China, a stronger Canadian dollar and the country's perennially weak productivity. If Budget 2012's focus on the resource sector was aimed at an audience in the West, then the targeting of manufacturing in this year's budget is a nod to Ontario — particularly the renewed funding for FedDev Ontario. With this and other measures, together with important changes on defence procurement and aerospace support, the government appears to be moving toward a more activist industrial policy.

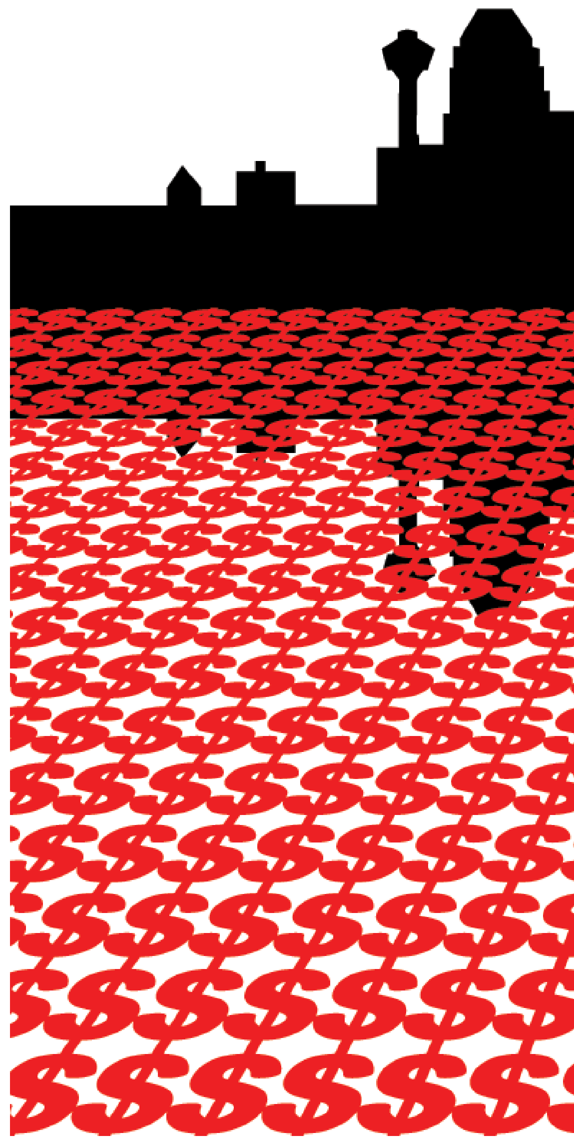
In addition to these three prominent themes, there are broader areas in the budget that may signal a shift in policy direction or warrant special attention going forward. The box below lists six key areas that are on the horizon, along with some related government policies from the budget.

In some of these areas the government seems to be signalling a more activist approach. For example, training funds as well as income assistance for on-reserve First Nations youth will both be structured as conditional transfers. This differs from the approach in last year's budget for the Canada Health Transfer, which Ottawa viewed as an unconditional grant, with the provinces effectively responsible and accountable for program delivery.

Also, notice how many of these important issues require negotiations with external stakeholders, from the provinces (issues 1 and 6) to First Nations (issue 2) and public sector unions (issue 3 — specifically public service compensation, pensions, sick leave and disability). The budget clearly declares the government's preferred outcomes to those on the other side of the bargaining table, in what are sure to be contentious discussions.

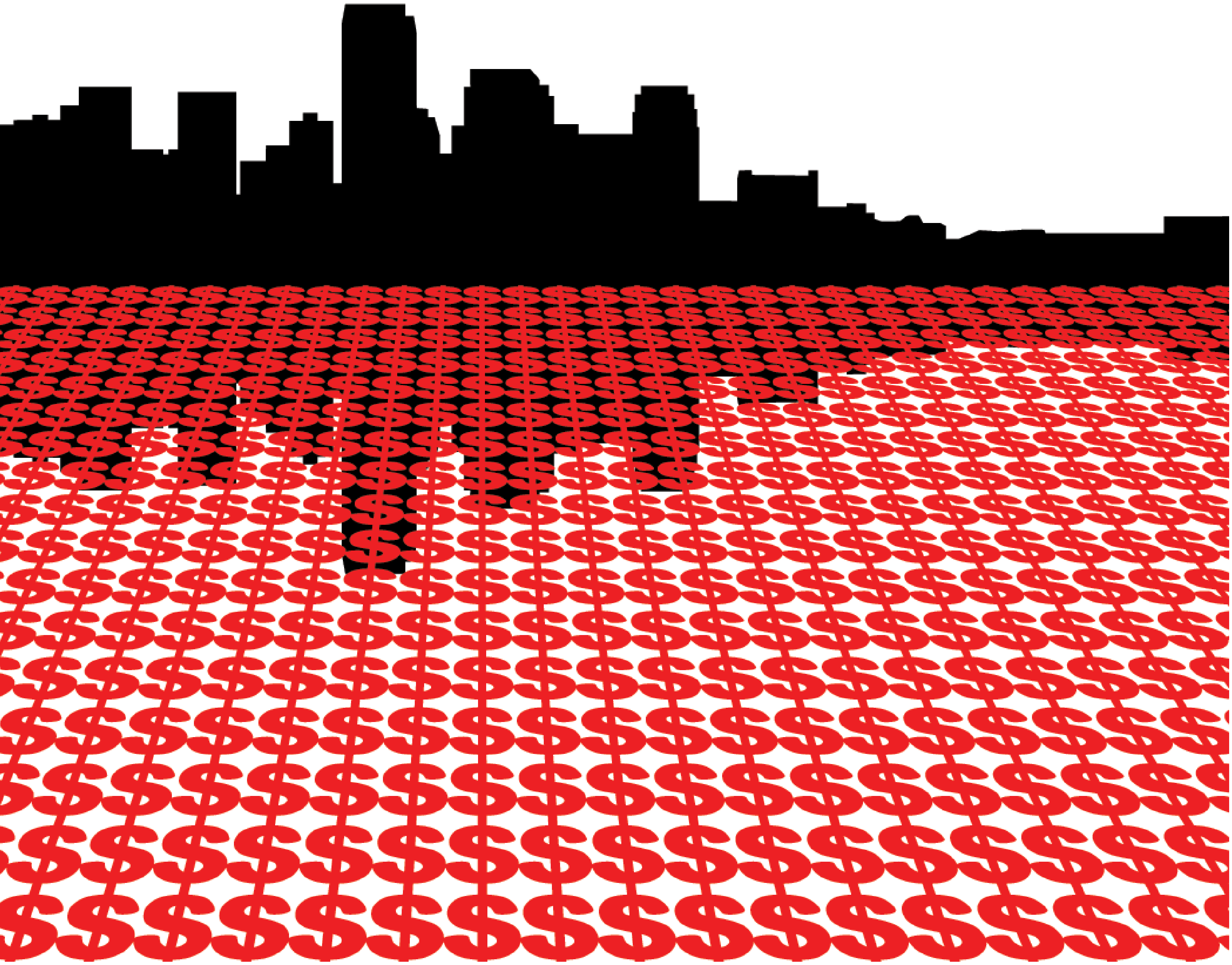
These issues also leave important questions unresolved. For example:

- Will the conditional nature of the Canada Job Grant, which requires matching funds from provinces and businesses, crowd out other provincial or firm-provided training?
- Will the federal government be able to hold departmental spending flat in nominal terms over seven years by improving public sector efficiency without significant service level impacts?
- Will the merger of the Canadian International Development Agency (CIDA) and the Department of



POTENTIAL FUTURE POLICY THEMES

1. Improving labour market efficiency	Changing training delivery with the new Canada Job Grant; renegotiating labour market agreements; reforming the Temporary Foreign Worker Program.
2. Constructively engaging First Nations	Developing a *First Nation Education Act*; making on-reserve income assistance for youth conditional on participation in training programs.
3. Tighter fiscal management	Increasing revenue through improved tax compliance; restraining federal departmental spending.
4. Improving international policy	Combining CIDA and DFAIT; increasing tariff revenues coherence on net, with rates rising for 72 countries and rate reductions on some products.
5. More activist industrial policy	Major defence procurements and other measures targeted to specific industries like manufacturing.
6. Enhancing financial regulation and oversight	Continuing attempts to establish a common securities regulator; addressing "too big to fail" in the financial sector.



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Foreign Affairs and International Trade (DFAIT) result in more coherent international policy and aid effectiveness, as some suggest, or will it further politicize and reduce Canada's development aid budget, as critics warn?

Finally, it is noteworthy that the budget devoted space to analyzing the gaps between Canadian and international prices for crude oil and natural gas, where these "Canadian discounts" represent a significant opportunity cost of not resolving Alberta's (thus Canada's) landlocked energy situation. Producers and cash-starved governments are painfully aware that without changes to the status quo they will continue to leave badly needed money on the table. These concerns highlight the urgency for better planning and strategic thinking to improve Canada's energy infrastructure to benefit all Canadians — all regions as well as current and future generations — in an environmentally sustainable manner. It is hard to see how that can happen without Ottawa's involvement.

In addition to what the budget did, equally important is what it did not do. While there were some welcome moves to improve tax compliance and neutrality, the budget provides no serious discussion of broader reforms to improve the efficiency of the overall tax system. Indeed, while the government was simplifying the tax code and striving for its neutrality, it was also introducing a new tax credit (the "temporary" First-Time Donor's Super Credit) as well as enhancing and extending existing ones.

While there are intuitive and sometimes defensible arguments for such tax credits individually, in the aggregate they can be highly inefficient and opaque levers for nudging desired behaviour. They tend to disproportionately benefit high-income earners, and they provide windfall gains to those who would undertake the behaviour even without the tax credit. Government should kick this bad habit, but it won't. Sadly, these targeted and easily sold measures have become indispensable parts of recent budgets and election campaigns.

Two other areas that are ripe for broader review were also overlooked: Equalization, and the employment insurance (EI) rate-setting mechanism. Because of elevated global commodity prices and a cap on the program's total payout, Equalization will not be able to bring several provinces up to the national average revenue-raising capacity — particularly now that Ontario is a recipient (as it has been since 2009). And the EI rate-setting mechanism should also be reviewed because it is not properly smoothing a key payroll tax rate over the business cycle — instead, the budget projects steady increases for four more years followed by a large drop in the premium rate in 2017.

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Scant attention was paid in the budget to some high-profile issues such as income inequality and productivity/innovation, which occupy the research agendas of many economists. Nor was there a "refreshed" global commerce strategy, though this is still expected to be announced later this year.

Overall, while the aggregate numbers were largely unchanged in Budget 2013, it may mark a subtle policy pivot for the federal government, laying the groundwork for a more engaged federal government. Whether it was driven by the imperatives of preparing for the next election or simply responding to external forces, it brought the government off the sidelines and into the game. ■