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Commentary

A DECADE OF TRUE NORTH IN CANADIAN PUBLIC POLICY

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Fighting COVID-19 is not like fighting a war

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Overview

The full scale of the economic losses from government-mandated closures in response to the pandemic came into focus with the publication of first-quarter GDP and government deficit projections. The extremely rapid move of governments in providing income support to Canadians invites the analogy to a war effort.

However, comparisons with the Second World War are misleading. The wartime expansion of government spending and debt was much larger, while their post-war reduction was facilitated by an unexpected surge in economic growth. Instead, the current fiscal challenge is more comparable with the austerity introduced in 1995 and 2010. Governments then relied mostly on spending reductions rather than tax increases to curb deficits while sustaining economic growth. Invoking the Second World War also recalls the myth that the sharp expansion of government spending during the war both ended the Depression and paved the way for postwar prosperity. Like many myths, this has little basis in fact.

Some people also invoke the analogy of the pandemic putting our society on a war footing to justify a permanent increase of government intervention in the economy. The government introduced its wide-range of temporary income supports in 2020 to keep capital and labour in place so normal operations could quickly resume. Canadians show no interest in

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permanently curbing their consumption to make room for an expansion of government transfers, even if some elites favour that shift. At a minimum, Canadians should be allowed the opportunity to vote on this proposed shift rather than having it imposed during an unprecedented crisis. Pundits like to say Canada has a new-found respect for blue-collar workers because of their efforts during the pandemic; that respect is meaningless unless it also extends to their consumption choices.

Introduction

The devastating economic impact from the closure of most non-essential economic activity due to the coronavirus pandemic became clearer with the release of GDP for the first quarter. Real GDP fell by 2.1 percent, entirely the result of a record monthly drop of 7.2 percent in March when governments ordered the closure of most non-essential economic activity. The economy will decline even faster in the second quarter, as Statistics Canada estimated real GDP contracted by a record 11 percent in April, leaving output already 15 percent below its first-quarter average. These losses mean that in just two months, Canada experienced a larger drop in its GDP than in all other post-war recessions combined.

The nosedive of incomes and employment was reflected in a comparable increase in government deficits. Overall, the Parliamentary Budget Officer (PBO) projects that Canada's nominal GDP will decline by about 16 percent for 2020, a loss of $400 billion of income (Office of the Parliamentary Budget Officer 2020). Given the unprecedented speed and depth of the economy's contraction and the explosion of government deficits, this economic quarterly report looks to how Canada dealt with previous economic and fiscal crises and whether this is an opportunity for government to restructure the economy.

Government deficits explode

Government budget deficits are on track to soar to about $400 billion from income support to Canadian households and businesses, plunging revenues from income, consumption and capital gains taxes, and soaring health care costs from the pandemic. The PBO projects the federal deficit rising from $24.9 billion before the pandemic to over $252 billion, not including the daily stream of new programs offered after April 24. That is why Parliamentary Budget Officer Yves Giroux said "In all likelihood, the deficit will be higher." Using the projections from the PBO, federal spending this year is expected to jump from 14.8 percent of GDP to 25.8 percent. Together with lower revenues, this inflates the deficit from 1.1 percent of GDP to 12.7 percent and raises the outstanding federal debt from 30.8 percent to 48.4 percent. The actual outcome is likely to be larger, but these estimates provide a good baseline for understanding the fiscal consequences of this crisis.

The federal deficit will likely exceed $300 billion after accounting for both measures taken in the last two months and the cost of inevitable bail-outs of provincial and local governments and sectors ranging from airlines to hospitality and seniors. A complete accounting of federal finances also would recognize the increased cost of public pensions to taxpayers as asset prices nosedived. The federal government acknowledged the importance and the inevitability of taxpayers subsidizing the pensions of its employees in its December 2019 Fiscal Update. It raised the deficit projection by $27.8 billion over the next five years for the cost of employee pensions as a result of lower interest rates (Department of Finance 2019, 33). Of course, since then interest rates have fallen even more precipitously across the yield spectrum.

> *Canada experienced a larger drop in its GDP than in all other postwar recessions combined.*

Provincial government deficits are projected to total $89 billion, up from $25 billion before the pandemic according to Scotiabank Economics (RBC earlier forecast provincial deficits of $63 billion). Even this forecast is likely to be optimistic. For example, the Financial Accountability Office (FAO) predicts Ontario's deficit will reach $41 billion, double what the Government of Ontario had earlier forecast (Financial Accountability Office of Ontario 2020). However, the FAO admits its forecast may underestimate Ontario's deficit because it assumes no bail-out of cities and that the reopening of the economy continues without interruption in the second half of the year.

The Federation of Canadian Municipalities forecast a collective shortfall of $10 to $15 billion over just the next six months, reflecting less revenue from transit systems and lower fees. This does not include potentially unpaid property taxes from the wave of bankrupt people and businesses that will not surface for months (people currently cannot file for bankruptcy because the courts are closed). Forbidden by law to borrow on their own except for capital projects and knowing that provincial finances already were stretched to the limit, municipalities made their appeal for help directly to the federal government.

Comparing the fiscal response in 2020 to previous crises

The most obvious comparison of the current crisis is with World War II.[1] While it is tempting to describe our society as moving to a 'war footing' to fight the coronavirus, the government's mobilization of resources in the Second World War was quite different in substance and scope than its response today. Federal spending initially increased from 10.5 percent of GDP in 1938 to 22.8 percent in 1941 with annual deficits near 5 percent of GDP. Starting in 1942, the increase in government spending became enormous, hitting a peak of 48.1 percent of the economy and boosting deficits to over 20 percent of GDP every year between 1942 and 1944. Defence spending drove the increase, accounting for 79 percent of all federal outlays at its peak (and directly contributing to higher interest payments as well). Another difference between the expansion of government spending in World War II and today is that the federal government was directly reallocating resources in the war, while today it is mostly transferring income to keep the economy as it was before the pandemic.

The federal debt soared from 22 percent to 160 percent of GDP during the war as tax hikes could not keep pace with the increase in spending. Still, the tax increase was historical, with the introduction of a widespread direct tax on personal incomes generating $687 million by the end of the war equal to 13.4 percent of GDP, up from a negligible $45 million (or 0.9 percent of GDP) in 1939. What had been a "class tax" on only the richest Canadians before the war was now permanently a "mass tax" on most incomes.

The huge increase in federal debt during the war was financed under unusual circumstances. With household and business spending sharply curtailed by shortages and rationing, there was no competing demand for funds from the private sector (borrowing by corporations and other levels of government fell outright to leave all loanable funds available to the federal government). At the same time, savings were encouraged either forcibly by tax increases or voluntarily by campaigns such as for Canada Victory Bonds. Canadians were willing to tolerate such privations and restrictions during a war, but have shown no willingness for compulsory government savings in peacetime.

How did Canada cope with the high level of debt accumulated during World War II? Initially, the government ran surpluses for six straight years after the war as spending almost returned to its pre-war level but taxes did not. Federal revenues totalled 14.0 percent of GDP at their post-war low in 1949, up from 9.5 percent in 1938 and 10.0 percent in 1939, while spending equalled 12.9 percent in 1948 versus 10.5 percent in 1938 and 12.1 percent in 1939. While some surpluses were sizeable, averaging 3.6 percent a year between 1946 and 1948 (equivalent to a $72 billion using GDP in 2019), they totalled only 13.4 percent of GDP. Therefore, budget surpluses accounted for only about one-tenth of the reduction in the federal debt to GDP ratio in the decade after the war.

Instead, most of the reduction in the debt load from 160 percent of GDP to 60 percent in 1956 in the post-war decade reflected unexpectedly rapid economic growth. GDP nearly tripled in one decade from $11.9 billion in 1945 to $32.1 billion in 1956. This surge in growth was the unplanned result of pent-up demand after years of depression and war, rapid productivity increases in the 1930s and 1940s, and a booming global economy as nations rebuilt from war and the globalization of trade and investment resumed under the auspices of international agreements such as Bretton Woods and the GATT. The extraordinary expansion of both demand and supply allowed the economy to grow rapidly with little inflation (outside of some shortages at the start of the Korean War).

It is worth underscoring how unexpected was the post-war burst of growth (Levinson 2016). Many economists expected the economy to return to recession or even depression after the war since “the great shadow of Depression-era unemployment still haunted the nation” (McDowall 2008, 100). Statistics Canada (then called the Dominion Bureau of Statistics) introduced its survey of employment and unemployment in 1945 partly because many economists expected unemployment would soar when millions returned from military service overseas (Usalcas and Kinack 2017). Certainly, the surge in growth was not the result of government planning; at the time, the government did not even have basic data on GDP or productivity.

Today’s fiscal circumstances are different

Government spending was completely different in the Second World War than in post-war recessions. The war was almost exclusively a federal operation since the federal government has sole responsibility for Canada’s foreign policy and national defence. While federal spending surged, provincial and local government spending hardly budged during the war.

By comparison, government spending to counter post-war recessions involved all levels of government. For example, the increase in spending to counter the 2008-2009 recession was about equally spread between the federal and other levels of government. This partly reflects how infrastructure spending financed by the federal government is mostly implemented by the provincial and local governments. However, as the PBO has noted, this allows for mischievous financial strategies by other levels of government to use federal money to finance projects they had already committed to undertake (Office of the Parliamentary Budget Officer 2018, 8). The result is that overall infrastructure spending does not increase as much as the federal government intends.

Tax revenues also behaved differently during this year’s pandemic crisis. Federal revenues rose sharply throughout the war, while in 2020 the PBO projects that federal revenue will decline by $60 billion due to sharply reduced income tax revenues and lower GST collections. The drop in the GST was much steeper than in 2008-2009 due to the steep drop in consumer spending, especially on services which normally do not decline precipitously during a recession.

Today, the prospect of reducing the debt/GDP ratio with a surge of income growth that inflates the denominator comparable to the immediate post-war years seems remote. Even before the current crisis, Canada had posted its slowest decade of growth since the 1930s, and unlike the 1930s there was no underlying improvement in productivity on which to pin hopes of a sharp improvement in growth prospects. Therefore, the model for reducing today's debt ratio is lowering the numerator using the austerity model adopted after the 1994 debt crisis and the 2008-2009 recession. Three-quarters of the deficit reduction after the 1994 crisis was achieved by lowering program outlays (from 16.4 percent to 13.0 percent of GDP); the rest was from raising revenues (from 11.5 percent to 12.7 percent).[2] After the recession ended in 2009, the $43 billion federal deficit was eliminated entirely by reduced program spending (from 15.9 percent to 12.8 percent of GDP).[3]

> *Before the current crisis, Canada had posted its slowest decade of growth since the 1930s.*

The template for austerity introduced in 1995 and 2010 followed the recommendation of most economists to rely primarily on spending cuts and not tax hikes. This is because spending reductions are less harmful to growth and long-term productivity than higher taxes. A recent IMF review of the literature found spending cuts boost business investment while tax hikes dampen spending (Alesina, Favero and Giavazzi 2018). By relying mostly on spending restraint, economic growth was sustained after austerity was adopted in 1995 and 2010. This is also the mix the federal government used after World War II, cutting its share of GDP almost to the level at the start of war.

Federal borrowing is always different from other governments in Canada during times of crisis because the federal government has a much larger borrowing capacity. This is already evident in the proposal from governments in Newfoundland and Manitoba for the federal government to borrow on behalf of the provinces, because markets charge the federal government less interest because of its lower likelihood of default.

However, the federal government capacity to borrow is not unlimited. This was clearly demonstrated when the government hit the "debt wall" in 1995 when bond markets balked at financing more debt issues. While theoretically the Bank of Canada could step in and buy debt by printing money, in practice it has refused to compromise its own integrity and independence for the expedience of bailing out politicians from the consequences of their profligacy. There is no sign that the Bank of Canada's position will change under new Governor Tiff Macklem, who is deeply imbued with the Bank of Canada's strong culture of independence after nearly 30 years at the Bank, including as its Senior Deputy Governor between 2010 and 2014.

Should governments use the crisis to restructure the economy?

This year's extraordinary increase in government spending and deficits apparently does not deter some from seeing an opportunity to restructure Canada's economy. After all, it is tempting to ask, if we can command the huge resources needed to contain the pandemic, why not use the occasion to make fundamental changes to our society?

However, this line of thinking is flawed and undemocratic. The vast deployment of government resources in response to the pandemic was intended to preserve the economy as it was. The 11-point hike in the federal government's share of GDP was to replace household and business incomes which collapsed almost overnight, especially in industries providing face to face interactions for services such as restaurants, hotels, travel, personal care, and recreation. This temporary income support was meant to keep labour and capital in place so these industries could resume normal operations as soon as the virus subsided, whenever that occurs. Making the increase in government spending permanent by financing programs such as a Guaranteed Annual Income, green energy infrastructure projects and higher-priced health care would be counter-productive to this short-term goal and harm long-term growth.

The idea of using a crisis to restructure the economy dates back to the myth that the gigantic expansion of government spending in World War II helped end the Great Depression and laid the foundation for post-war prosperity. As a result of its placement between 1930s depression and post-war prosperity, the war has "acquired almost mythological significance in bridging the two storylines, although it has in fact received little detailed examination from macroeconomists and economic historians" (Field 2011, 80).

The myth that wartime government spending ended the Depression is baseless. The Depression was well on its way to ending with a sharp recovery after 1933 despite little direct aid from government (just as 1920-21 Depression ended without government intervention).[4] However, a premature tightening of fiscal and monetary policy in the US triggered another downturn in 1937.

Alexander Field points out that the enormous demand shock of wartime spending only could work if there also was a corresponding supply shock to productivity, but there is little evidence that the war generated productivity lessons that could be carried forward into peacetime. In fact, the rapid mobilization and then demobilization of labour and capital probably slowed productivity "as it first force-fed very rapid expansion in a limited number of war-related sectors…and then imposed equally rapid contraction" (Field 2011, 80-81). After all, if government spending was so crucial to the wartime expansion, then why did lowering government spending by 1948 to the same share of the economy as in 1939 not dampen the economy?

> *The myth that wartime government spending ended the Depression is baseless.*

Field lays out many of the arguments why the war was not as beneficial for postwar prosperity as many assume. The US economy, which spearheaded postwar growth, was only on a war footing from about mid-1942 to late 1944, too short a period "for the putative effects of learning by doing to have established the foundation for postwar prosperity" (Ibid., 24). There is little evidence that experience with wartime production was beneficial when transferred back to a civilian economy. On the contrary, he concludes "the war was detrimental to productivity growth in the civilian sector. It drained skilled workers, managers, and plant and equipment investment from these industries, creating a productivity shortfall that had to be made up afterward" (Ibid., 24). There was little net gain in output per hour outside of munitions industries during the war, despite the sharp upward trajectory of both inventions and productivity during the 1930s that one would have expected to carry over into the early 1940s.

A further myth is that the federal government developed a taste for controlling the economy during the war that it never relinquished, supposedly shifting from defence to social spending. In fact, very few social spending programs were introduced in the 1950s, apart from Family Allowances in 1945 and a small increase for old age pensions. By far the largest increase in federal outlays in the 1950s was for defence, which increased during the Korean War and then never shrank, followed by interest payments on debt. Medicare and many other social programs were not introduced until the 1960s and 1970s, which then fuelled the growth of government debt and over-heating of the economy that helped inflation take off. Government planners, not public demand, drove this increase.

Restructuring the economy is problematic no matter what course the virus takes. On the one hand, if the virus does subside, either on its own or due to a vaccine, we would expect Canadians to resume spending on personal services.

If on top of this we add a substantial increase in government spending, soon the economy will surpass its capacity limits. While not at full employment before the crisis, Canada was not several percentage points short of it (the Bank of Canada estimated the output gap was about 1 percent late in 2019 (Bank of Canada 2020, 10)). We cannot simultaneously resume normal economic activities and fundamentally restructure the economy, nor would we want to.

On the other hand, if the virus disrupts spending for a prolonged period, Canada faces a very difficult transition for its capital and labour. People little versed in economics warn of stranded assets in our fossil fuel industry, but that would pale compared with the hundreds of billions potentially stranded in aerospace, urban transit, hotels, and commercial and office buildings. For workers, as widely noted, income and job losses have been concentrated in services industries with low levels of skill, education and pay. How exactly does a former waitress with a high school education transition to an economy shifting to government infrastructure projects or health care? At a minimum, it would require years of income support for millions of people while new skills were acquired, something that has proved difficult in the past even without the lower efficiency of the online courses the virus would necessitate. Restructuring would be a painful and costly exercise at a time when the economy is still struggling with the pandemic.

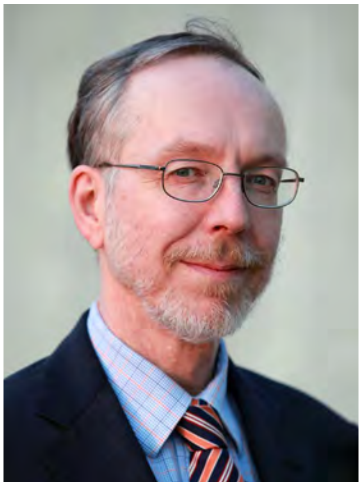
> *Restructuring the economy is problematic no matter what course the virus takes.*

A more basic question is, do Canadians want an economy restructured along these lines? In the short-term, higher government spending is replacing some of the record decline in household spending, especially on services that form the basis of much social activity. However, humans are inherently social beings; Canadians spend substantial amounts on restaurants, hotels, travel, cinemas, gyms and other personal services, preferring a large variety of these activities at low prices. It is unlikely people will permanently give up this network of social activities to finance a guaranteed income, green energy infrastructure, or more health care.

At a minimum, plans to rebuild and restructure our economy need to be transparent, so Canadians can decide if they accept this trade-off on a permanent basis. A temporary willingness to make sacrifices during a crisis should not be confused with a permanent shift in preferences. In past crises, Canadians postponed consumption for the common good, but not forever. As World War II ended, a weariness with sacrifice resulted in the defeat of Winston Churchill in 1945. In Canada, Mackenzie King's Liberals were reduced to a minority government running on the slogan “Build a New Social Order” and he personally lost his seat. People wanted to spend on their personal well-being after two decades of pent-up demand. Similarly, austerity programs are best implemented quickly before people lose the motivation for shared sacrifice.

Unless Canadians choose to lower their consumption for more government spending, plans to impose a restructuring look like another elitist attempt to tell ordinary people how to live. The pandemic supposedly made us more aware of the contribution of blue-collar workers, but the sneering contempt of many for blue-collar consumption choices remains just below the surface. Even worse than slowing economic growth by diverting resources into less desirable activities, imposing such a choice undermines democracy.

About the author



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Endnotes

1 All data prior to 1961 is from Social Science Federation of Canada and Statistics Canada 1983.

2 For a complete account of the 1995 fiscal reforms, see Crowley, Murphy, and Veldhuis 2012.

3 All the data in this section is from the Department of Finance, Fiscal Reference Tables 2019.

4 For a detailed account of the 1920-1921 depression, see Grant 2014.

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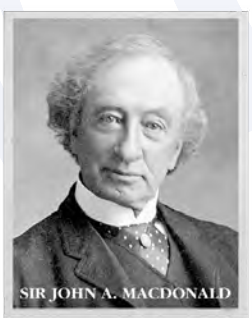
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