CALEDON
INSTITUTE OF
SOCIAL POLICY

caledon commentary

November 2005 ISBN # 1-55382-162-9

The Next Recession: Anyone Got a Plan?

After the disastrous response to hurricane Katrina, governments around the world began to review their emergency response plans for natural disasters. This is all to the good, but looming in our future is another type of emergency that governments do not even acknowledge.

Sometime soon – likely within the next two or three years – there will be a serious economic slump.

No one knows if there will be a sharply defined moment when the economy turns. But turn it will. For the last few centuries, the world has gone through economic upturns and downturns. It is at best naïve to think that the business cycle has now been tamed: It is simply foolish to govern without any plan for an eventual recession.

We can see the future only through a dim haze of probabilities, so we cannot know the form that the next economic downturn will take. It could be a classic recession with a stable or even deflating currency, or it could be a return to the bad old days of stagflation combining recession with a dose of inflation. Interest rates could go a lot higher, or they could be even lower than today. We do not know if the immediate cause will be a collapse of the US debt pyramid or some other unforeseen event. However, we do know a few things for certain.

Unemployment will go rocketing upward, likely passing into the double-digit zone as it did in the recessions of the early 1980s and 1990s. Construction of new buildings and residences will plummet. All retail sales will fall, especially durable goods – among them, critically for Ontario, vehicle sales. Corporations will sharply reduce capital spending and many companies will reduce dividends and income distributions. Government revenue will fall sharply, corporate income tax fastest of all, but followed closely by personal income taxes and consumption taxes. Although property tax is relatively stable through the economic cycle, other forms of municipal revenue, such as licences and building permits, will shrink to a tiny trickle.

While government revenue is melting away, government costs will go in the opposite direction. With rising unemployment, welfare and Employment Insurance caseloads – which have fallen significantly in recent years – will once again take off and payouts will go up by billions of dollars. Income-related tax credits, such as the Canada Child Tax Benefit and GST credit, will cost more because incomes will be lower. Even seemingly unrelated areas, such as postsecondary education and associated student loans and grants, will experience increased demand as young adults sensibly calculate that they would be better off spending a year in school instead of a year being unemployed. Pressures on health care and social services will rise, due to increased poverty, mental health problems and the stress of economic uncertainty.

Revenue down and spending up means that deficits will be hard or impossible to avoid. How will governments react?

Many governments now have some form of 'balanced budget' legislation requiring them to balance their revenue and expenditure each year. Even those governments that do not have such legislation will be under significant pressure to meet popular expectations of balanced budgets. Much of Canada's media and corporate sector equate balanced budgets with moral virtue, and will doubtless continue to campaign vigorously on behalf of virtue, whatever its costs. This means that most governments' first response could be to cut expenditures in the midst of a recession, therefore compounding the economic downturn. A few, in desperation, might even seek to raise taxes.

While Ottawa does not have balanced budget legislation, it has the next thing to it. Employment Insurance legislation passed as part of the 2005 Budget requires that premiums be set to equal next year's forecast costs. During the next recession, premiums will ratchet up while employers are shedding more workers. The federal Cabinet can override this legislated increase, but it will take some courage to do so. We could face the paradoxical and self-defeating prospect of increasing Employment Insurance payroll taxes at the same time as employers are laying off employees to reduce costs.

The effects of a recession on the current structures of fiscal federalism will also be predictably disastrous. Some provinces, territories and municipalities will be much harder hit than others. If the price of oil remains high, Alberta and to a lesser extent Saskatchewan (and perhaps even Newfoundland) may sail through a recession with their provincial revenue bases relatively untouched. The two largest provinces – Ontario and Quebec, which rely upon manufacturing – will be badly hurt. Most likely, the auto industry will all but grind to a halt and Ontario's revenue will plummet.

The fiscal imbalance between provinces will become extreme. But Ottawa's fiscal transfers to provinces have no stabilization component and no mechanism to compensate for rapidly changing economic circumstances. Federal-provincial tensions will escalate as governments stumble from one temporary fix to another.

In Ontario, the previous provincial government made municipalities responsible for a large portion of the costs of welfare and other social programs, while removing measures to shield municipalities in a time of economic downturn. Many Ontario municipalities will simply be unable to cope, no matter what they do. Some municipalities in other provinces may also be hard pressed just to maintain daily operations. Senior orders of government will be scrambling to invent *ad hoc* responses to threatened municipal bankruptcies: Shades of the Great Depression of the 1930s.

No doubt, if the recession goes on for more than a few years, a saner approach will gradually begin to emerge. Slowly, governments will adopt a more flexible response to the real circumstances of the day. Formulae will eventually be worked out to help provinces, territories and municipalities that need help most. We will muddle through.

But in muddling through, our governments will have exaggerated the worst effects of the downturn. We will likely make the worst off bear the greatest burden, by failing to ensure adequate income security and perhaps even cutting back on existing programs. We will fail to use the opportunity of unemployed national resources to build needed capital works improvements that could offset some of the effects of a recession while creating a lasting benefit. Muddling through means that we will emerge a weaker, poorer nation – not a stronger, more productive nation.

This does not have to be. Just as governments have rightly assumed some urgency in planning for natural disasters, they should also get busy planning for an economic emergency. Preparing a plan for the next recession will involve four critical challenges.

First, governments have to start thinking about, and talking about, rational fiscal and monetary policy in the event of a recession. Canada has made great strides in reducing its public debt – now among the lowest in the OECD – and an economic downturn is the time to realize some of the benefits. If there is a recession, governments can neither cut programs nor raise taxes without making things worse: There must be deficits. Further, monetary policy cannot remain singlemindedly fixated on inflation. Instead, monetary policy should also assume part of the burden of helping the economy climb out of a slump. The media might help this process along by asking politicians this simple question: What would your economic policy be in the event of a recession?

Second, governments should begin now to prepare a list of necessary capital projects that will provide jobs and improve our physical and social infrastructure. A recession is the perfect time to catch up on our backlog of postponed public works, whether they are unglamorous necessities – such as sewers that need repairing – or flashy new public transit facilities. With tens of thousands of construction workers unemployed, a recession would be the right time to build the social housing most of our cities and towns desperately need. However, it takes years to get a capital project planned and ready to proceed. If needed public works are to be built during a recession, an active inventory of viable projects has to be created now and brought to a status where such projects can be rapidly initiated.

Third, federal, provincial and territorial governments need to restructure Canada's income security system so that it can cope with a period of poor economic performance. As noted, the recent Budget legislation removed the automatic stabilizing role of Employment Insurance. Because it ended cost sharing in 1995, the federal government no longer supports provincial welfare with matching dollars. The next recession will be the first since the 1960s in which provinces will face escalating welfare costs without any federal assistance. More importantly, neither Employment Insurance nor welfare is functioning well in providing adequate assistance to unemployed Canadians who need financial support. Federal, provincial and territorial governments need to get together and start down the road towards designing a better income support system. The Caledon Institute is preparing recommendations on a new 'architecture' for Canada's income security system that could be the starting place for federal-provincial/territorial discussions.

In Ontario, municipalities will certainly be unable to pay their portion of welfare costs and the system will break down, amidst great acrimony. A realistic plan for dealing with excessive municipal costs in the event of a recession needs to be put in place while it can be calmly considered, and before rating agencies start downgrading municipal debt.

Fourth, and related to all of the above recommendations, the structure of fiscal federalism must be renewed. At present, fiscal federalism – by which we mean the way that federal and provincial/territorial governments, and to a lesser extent municipalities, share their revenues and their taxes – has become largely a series of *ad hoc* arrangements without an overall governing concept. Many Canadians have lost faith in the fairness of the system. Fiscal federalism will come under even greater stress when there is a recession. A new system needs to be established that will be effective in sharing risks and rewards among governments, in encouraging economic and social prosperity, and in withstanding the strains of bad economic times.

Conclusion

Canadian governments are completely unprepared for the next economic emergency – a recession of some form that will inevitably occur sometime in the next several years. The structures and systems need to be set up now, so that Canadians can cope with an economic downturn. With good planning and adequate preparation, we can provide a strong safety net for Canada and emerge from a recession sooner and stronger, having created some of the needed public infrastructure that can be the foundation for another decade of prosperity.

Michael Mendelson

Michael Mendelson is Senior Scholar at the Caledon Institute of Social Policy.

1600 Scott Street, Suite 620
Ottawa, Ontario, Canada
K1Y 4N7

Phone: (613) 729-3340 Fax: (613) 729-3896
E-mail: caledon@caledoninst.org
Website: *www.caledoninst.org*