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# Why Fiscal Policy Matters for Canadian Prosperity

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## EXECUTIVE SUMMARY

Canada ranks among the world's most successful advanced economies, combining democratic governance, prosperity and social stability. Strong institutions, respect for the rule of law, a highly educated workforce, effective labour markets and a comprehensive social safety net are the foundations for a high quality of life in Canada. Comparative evidence shows that Canada consistently performs in the top tier of advanced economies across a range of economic and social indicators. Sound fiscal policy is crucial to sustaining these strengths. Policy is the set of government decisions regarding taxation, spending and borrowing, which, while often technical and overlooked, plays a decisive role in shaping long-run prosperity.

However, Canada faces some serious economic challenges, most of which fiscal policy will directly influence. First, growth in per capita GDP — a key measure of average living standards — has lagged behind that of Canada's global peers for several years and has declined outright since 2022, an unusual and troubling development outside of recessionary periods. Second, income inequality has risen, with higher income households enjoying a disproportionate share of growth while many low- and middle-income Canadians must cope with stagnant pre-tax incomes. Although Canada's tax-and-transfer system mitigates inequality, weak underlying income growth is concerning.

Third, Canada's long-standing productivity problem continues to undermine wage growth, profitability and competitiveness. Low levels of business investment in machinery, equipment and intellectual property — relative to other advanced economies — are a big contributor to this weakness. Fourth, housing affordability has deteriorated dramatically following decades of rapid increases in prices and rents, transforming what was once a problem mainly for the lowest income Canadians into a widespread constraint affecting millions of households. Fifth, Canada faces the dual challenge of sustaining the economic benefits of natural resource development, particularly in energy, while meeting environmental and climate commitments.

Three more challenges have arisen due to U.S. protectionism under President Donald Trump. Canada's deep integration with the U.S. economy — long supported by free trade agreements — is strained by higher tariffs and increased uncertainty, raising new fears about competitiveness, diversification and economic resilience.

This paper frames a comprehensive fiscal policy agenda organized around taxation, government spending and public debt. Key tax-related questions include whether Canada needs a full-scale tax system review; how to finance new spending commitments; the growth effects of higher income tax rates; the potential benefits of shifting toward expenditure-based taxes; and the need for tax competitiveness, especially for corporations.

Priorities on the spending side include improving program review and evaluation; reassessing federal transfers to provinces; refining the social safety net; scrutinizing business subsidies; and evaluating proposals to distinguish operating from capital budgets. Regarding deficits and debt, the paper highlights concerns about debt sustainability, bond market perceptions and the political challenge of communicating the long-term costs of high public debt.

Canada's future prosperity depends on thoughtful, disciplined and well-designed fiscal policy. Economic success doesn't depend on one single factor; rather, it encompasses income growth, equity, productivity, innovation, fiscal resilience and security. The right fiscal tools can advance these objectives but only if they are carefully matched to specific problems, rigorously evaluated and adjusted over time. Governments must reject policy complacency and replace it with action grounded in fiscal prudence and evidence-based design, if the economy is to continue to sustain Canadians' prosperity.

## INTRODUCTION

Canada is a remarkably successful society when compared to other advanced countries. We are democratic, prosperous and peaceful — a surprisingly rare combination on today's geopolitical landscape. Good governance and respect for the rule of law provide a foundation for our many successes. Canada's workforce is highly educated and its businesses are innovative. Our labour force participation rate is high and our labour markets are effective in matching employers with job-seeking workers. Canada's social safety net — including universal public education and health care, public pensions, employment insurance and support for low-income families — ensures that most Canadians can participate in our prosperity even when facing the inevitable vagaries of a market economy. Overall quality of life in Canada is high. As Browne and Page (2025) show, in a ranking of several metrics across 15 advanced countries, Canada usually appears in the top half or 1/3 of the countries.

Many of our economic strengths relate to Canada's fiscal policy, which is the topic of this essay. Fiscal policy describes the collection of government policies pertaining to taxation, spending and borrowing. Though its details are often technical and complicated, and boring enough to be ignored by most Canadians, a central theme of this essay is that fiscal policy matters tremendously for our prosperity. Any individual policy change may have only a modest effect, but the combined effect of the collection of policies is profound.

As successful as Canada is by today's global standards, we also face several serious economic challenges, some of which are longstanding problems while others are more recent. Each of these challenges connects in some way with fiscal policy.

The most comprehensive measure of average material living standards in any country is income per person, measured as per capita gross domestic product (GDP). GDP growth in Canada has lagged far behind that in many advanced countries for several years, and since 2022, per capita Canadian GDP has fallen in absolute terms. Outside of economic recessions, advanced economies rarely experience actual declines in per capita GDP.

One important income measure not captured by per capita GDP is the distribution of income across households. Income inequality has been growing in recent years and higher-income households have captured many of the fruits of economic growth; incomes for many low- and middle-income households, in contrast, have been stagnant. While Canada's tax-and-transfer system is quite effective in dampening the effects of this rising inequality, the sluggishness of pre-tax incomes for many low- and middle-income Canadians should not be ignored.

The key driver of average incomes in a country over the long term is labour productivity, but Canada's productivity, both in its level and its growth rate, has been dismal for several years. Productivity growth can improve both workers' wages and firms' profits while also permitting reductions in prices, thus helping all major groups in the economy. Though there are many sources of productivity growth, most economists view business investment in machinery, equipment and intellectual property to be of primary importance. However, Canadian business investment has been much lower in recent years than in other advanced economies.

During the first two decades of this century, the average rental and purchase prices for Canadian housing increased by about 325 per cent in dollar terms; during the same interval, average incomes increased by only 90 per cent. The result, as we all know, has been a dramatic deterioration in housing affordability in all parts of the country. Whereas housing unaffordability was traditionally a problem only for Canadians with the very lowest incomes, today it is a significant problem for millions of low- and middle-income Canadians.

Canada's economic prosperity has long had a solid foundation in its production and export of natural resources, and in recent decades its energy resources have been an especially important source of our prosperity. The development of these energy resources has always been challenging, but it has become more difficult in the face of the climate crisis and policy commitments to reduce greenhouse gas emissions. Improving the development of our natural resources, while continuing to protect our natural environment, is a crucial economic challenge.

The five challenges just described have existed for years. To this list, we can add three others which have become prominent since the re-election of U.S. President Donald Trump.

Canada's prosperity has long been tied to its close economic relationship with the United States, and formal free trade agreements in 1989 and 1994 (adding Mexico) have been central in creating a highly integrated North American economy, with benefits accruing to all three countries. But with Trump's imposition of high tariffs on a wide range of Canadian products, we urgently need to redirect some of our exports toward other countries, thereby reducing our reliance on the vast but closing U.S. market.

Trump has also pushed America's NATO allies to increase their defence spending, to make the alliance less dependent on decades of U.S. military largesse. Canada has long been a laggard on this front. The new Carney government has recently joined Canada's NATO allies in committing to an increase in defence spending to five per cent of GDP by 2035, much higher than Canada's current level of about 1.4 per cent. Such an enormous increase in annual spending, equal to well over \$100 billion in today's dollars, presents serious challenges to the federal government's fiscal framework.

Finally, Canadian sovereignty has not been at risk since Confederation and our multi-faceted relationship with the United States has been the foundation for 150 years of peace, security and prosperity. But with a sitting U.S. president talking of annexing Canada and other nations, the issue has resurfaced with a vengeance. The result has been a renaissance in Canada of both patriotism and economic nationalism. In addition, with climate change leading to more navigable waters, and with China's economic rise and Russia's growing belligerence, Canada's Arctic is now seen to be especially vulnerable. Some of our increase in defence spending will be committed to developing and protecting Canada's North.

These are enormous challenges for the Canadian economy and each relates to fiscal policy in various ways. This essay will lay out the four largest components of fiscal policy — taxation, purchases, transfers and borrowing — and explain why they matter and how they connect to Canada's economic challenges. While we mention provinces, territories and municipalities at various points to offer a more complete picture of Canada's overall fiscal landscape, our focus is mostly on the federal government. Before concluding, we pose some policy questions worthy of further discussion.

## TAXATION

Canadian governments manage a complex portfolio of taxes. In any given year, Canadian governments collect revenues equal to about 41 per cent of GDP (Statistics Canada 2025). One important policy question often debated is whether government is “too big” or “too small.” By this measure, Canada has more government than many other advanced countries but less than some others. Among the OECD group of advanced countries, for example, Canada falls near the middle of the pack; France tops the list at 44 per cent of GDP while Mexico is at the bottom with 18 per cent (OECD 2024). For the average OECD country, tax revenues are 34 per cent of GDP. As we will see throughout this essay, the question of the optimal size of government is not at all easy, as much depends on the details of the policies being discussed.

The federal and provincial governments levy progressive taxes on personal income, for which a standard tension is the choice between higher rates and a broader tax base with lower rates. Tax rates, if kept very high, can create significant obstacles to employment and growth. The tax base, if kept very broad, tends to limit the government's ability to curry favour with specific groups by offering various credits and exemptions. The tension between what is economically desirable and politically expedient is rarely more present than in tax policy.

The federal and provincial governments also levy taxes on corporate income, although these tend to have a flat-rate structure, with the exception being a higher rate for larger businesses. Most non-experts see corporate taxes as a necessary element of an overall tax system that is fair and equitable, as many people would argue the need for corporations to pay their fair share of the overall tax burden. In contrast, economists tend to favour a system with low corporate taxes because of the concern that high corporate taxes lead to less investment and innovation and, through this channel, to less long-run economic growth. In their view, corporate profits, once they are distributed to business owners in the form of dividends, can be adequately taxed in the recipients' hands.

One other issue regarding the design of our income tax system is the mobility of labour and capital. Financial capital is generally much more mobile across international boundaries than is labour. One implication of this difference is that any country likely has more ability to set its personal income tax rates without regard to what is happening in other countries than is the case for corporate income tax rates. Since labour is not particularly mobile internationally, higher personal income tax rates in Canada may not lead to much outflow of labour, thereby permitting the high tax rates to persist. In contrast, capital's mobility means that higher corporate tax rates in Canada than in other advanced countries may lead to an outflow of investment opportunities here, with negative implications for our investment and subsequent growth. This may lead the government to reduce Canada's tax rates to better align with those elsewhere. This is often portrayed as maintaining a more competitive corporate tax structure.

The federal and most provincial governments also impose taxes on expenditure — the federal government with the GST and the provinces with their provincial sales taxes. A key advantage of such expenditure-based taxes is that, unlike income-based taxes, they do not apply to interest income and thus do not provide an economic disincentive to saving. A movement away from income taxes and toward expenditure-based taxes encourages saving and, by driving down interest rates and stimulating investment, helps to drive long-run economic growth. This logic partly motivated the Mulroney government's major tax reforms and introduction of the GST in the late 1980s and early 1990s.<sup>1</sup>

In addition to these three main forms of taxation, four others deserve mention. First, provinces control natural resources in Canada and impose royalties on the income from resource development. The province's residents own these resources and the royalties represent their share of the economic value of the developed resources. As is the case for all taxes, however, a province's setting of the royalty rate involves an important trade-off. Setting the royalty rate very low will encourage development but will deliver fewer benefits to that province's taxpayers. Setting the royalty rate much higher appears to be fairer to taxpayers but might result in little or no development of the resource and thus reduces overall royalty earnings.

Second, municipalities levy taxes on property values and this revenue represents a large part of their total income, with significant revenues also coming from transfers from provinces (and occasionally from the federal government). The specific development charges that municipalities impose on real estate developers, which have become more important in recent years, are a key issue in ongoing concerns about the rising costs of building new homes. These charges raise the cost of newly built homes by tens of thousands of dollars per structure.

Third, there is a vast array of credits, deductions and exemptions — tax expenditures — that exist for income and expenditure taxes. For example, according to the Government of Canada (2025a), approximately \$150 billion annually in federal tax revenue is forgone through tax expenditures which favour specific activities and/or types of income. Many of these tax expenditures, often characterized by their critics as boutique tax credits, have been added to the tax system in response to lobbying by specific groups of taxpayers. Critics allege that such tax expenditures complicate the tax system and that their elimination would permit a wider tax base to be taxed at lower rates, thus enhancing the system's overall effectiveness and boosting economic growth.

The fourth and final form of taxation to mention here is one that for decades in Canada was unimportant but has now returned to the policy scene — tariffs, which are taxes applied to the value of imported products. Domestic importers of the targeted products pay tariffs and the revenues accrue to the Canadian government. In most cases, the prices the foreign sellers receive are unchanged, although there will typically be some reduction in their incomes as the Canadian buyers reduce their import quantities in response to the higher (tariff-inclusive) prices.

To examine the effects of various taxes, it is useful to make a distinction between the micro and the macro effects. Any tax's micro effects come from how that tax changes the allocation of resources — production, employment, expenditure — across individuals, firms, sectors or regions. A tax's macro effects come from its impact on aggregate demand or aggregate supply, and then on GDP and prices.

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<sup>1</sup> Some readers may wonder why such an increase in saving does not lead to a decline in aggregate demand and thus a decline in GDP. This would likely be the short-run effect of an increase in saving, but over the longer term as the economy returns to full employment, the dominant effect would be on interest rates, investment and growth.

There are as many examples of taxation's micro effects as there are taxes themselves. Here are a few. The special income tax treatments embedded within RRSP and TFSA contributions are designed to encourage more saving (and less spending) by the private sector, which not only reduces the demand on the public purse for future income support payments but also provides an overall stimulus to saving, investment and economic growth. Investment tax credits and accelerated depreciation allowances are both designed to enhance the after-tax profitability of investment, thereby stimulating investment, productivity and long-run growth. The Carney government's recent removal of the GST on the purchase of new homes for first-time buyers is designed to enhance both the demand for and supply of new housing. Canada's recent tariffs, imposed as a response to Trump's new tariffs on a range of Canadian products, are designed to shore up employment and production in those sectors.

As for the macro effects of various taxes, economists focus on their impact on overall spending in the economy. The Carney government's middle-class tax cut, which reduces the rate applied to the lowest income tax bracket and thus applies to high-income and low-income earners alike, is explicitly designed to increase disposable income and purchasing power for all Canadian taxpayers. How each person spends their higher income will have various micro effects across the economy, but in macro terms this tax cut will undoubtedly lead to an increase in overall aggregate demand and thus to a rise in GDP, at least for a while. In contrast, tariffs imposed on Canadian imports directly raise the prices of the imported products and generally permit the domestic producers of import-competing products to raise their prices. These price increases reduce the purchasing power of Canadians' incomes and lead to a fall in total spending and GDP.

## GOVERNMENT PURCHASES

Government spending comes in three broad types. The first is the government's purchases of goods and services — salaries and supplies for public servants, the building and repairing of roads and highways, new equipment for the military, consultants to advise on various policy issues and so on. The second type is transfers to individuals, businesses, organizations and other governments. Unlike purchases, transfers do not represent a market transaction. Instead, they are a gift from the government to the recipient, sometimes in return for certain actions (such as a production subsidy to a private business) but are often made without the expectation of any specific behaviour by the recipient (as is the case for most federal transfers to provinces). The third type of government spending is the payment of interest to the current holders of government debt. Technically, these payments are for a service rendered (the earlier lending of funds) but they are usually discussed separately from the other two spending categories.

Combining all governments in Canada, the purchase of (non-interest) goods and services currently accounts for about 58 per cent of total spending (Statistics Canada 2025), or 23 per cent of GDP. Transfers to businesses, individuals and organizations account for about 30 per cent of total government spending, roughly 12 per cent of GDP. Debt-service payments make up about seven per cent of government spending, or three per cent of GDP. The remainder of this section focuses only on government purchases of goods and services. Transfers and debt-service payments are covered in later sections.

As with taxes, a government's purchases have both micro and macro effects on the economy. The micro effects are the impacts on specific individuals and firms, sectors or regions — typically seen as the bread and butter of politics simply because governments have always courted favour with specific groups of voters through their purchasing decisions. After all, any purchases by

government generate income for the individual or business on the other side of those transactions. The macro effects are the impacts of the government's action on overall economic performance, including employment, GDP and the price level. These effects are less focused on specific groups but nonetheless still garner much public attention, especially during economic crises when the government's policy responses are widely publicized and discussed.

The Carney government's recent decision to increase defence spending is an excellent example of the micro effects of government purchases. Higher salaries paid to members of the Canadian Armed Forces will make it easier to retain and recruit soldiers, thus influencing the labour market decisions of thousands of Canadians. Employers in other sectors of the economy will then need to work a little harder and pay higher wages to draw workers away from a now more attractive military. Greater spending on military equipment — not all of which will be purchased from foreign allies — will lead to increased demand for domestic production. The result will be increased employment and output in Canada's defence production sector. These spending decisions will also have regional implications and the government will surely strive to ensure that the associated economic benefits accrue to all regions, even if the result of doing so may be less cost-effective military procurement overall.

Greater government spending is required today to face some of our largest challenges, but at other times smaller government is needed, as was the case in the mid-1990s when the federal and provincial governments were rightly concerned about the implications of excessive spending and high government debt. But if new government spending generates micro benefits for many, then cuts in spending generate micro costs and so cutting government spending is almost always more politically challenging than raising it. The late Milton Friedman emphasized the power of the entrenched economic interests of beneficiaries of government spending when he said that "nothing is so permanent as a temporary government program." Mindful of the need to finance some of the new government spending with reductions in some existing programs, Prime Minister Mark Carney has initiated a comprehensive spending review, with the intention of reducing the federal government's operating expenditures by 15 per cent within three years. At the same time, however, Carney has taken off the table major transfers to provinces and individuals; this decision will clearly improve the political optics of the overall exercise of cutting government spending, but these transfer items are so large that their removal from consideration makes the overall task of cutting expenditures much more difficult. As Lester (2025) argues, this comprehensive review is unlikely to deliver the magnitude of cuts the government is announcing.

To examine the macro effects of changes in government spending, economists usually focus on the new spending's impact on aggregate demand and how this drives changes in GDP. Central to this discussion is the fiscal multiplier, the term used to explain how a \$1 billion increase in government spending often leads to an overall increase in GDP of more than \$1 billion. The fiscal multiplier has a long history in macroeconomics and is of primary importance during recessions when governments consider policies of expanded spending designed to raise employment and output, thereby dampening the recession's contractionary effects.<sup>2</sup>

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<sup>2</sup> Our discussion of the fiscal multiplier focuses on discretionary fiscal stabilization, which is decisions that governments make in their spending or taxing plans to stabilize GDP. Perhaps equally important is the automatic stabilization of the economy which takes place because of our tax-and-transfer system's design. As GDP rises, more taxes are collected and fewer transfers are made, thus dampening the initial rise in GDP; as GDP falls, fewer taxes are collected and more transfers are made, thus dampening the initial fall in GDP. Many economists argue that automatic stabilization is more effective than discretionary stabilization, not least because it happens without the slow and complex decision-making process inherent to democracies.

The multiplier's size is crucial because it determines how much new government spending is required to raise GDP by any given amount. Another crucial issue is the time pattern of the multiplier's impact. These two issues are closely connected. Generally speaking, the fiscal multiplier is larger over the short term, say between one and three years, than it is over the longer term of four or more years. And even in the shortest interval, the fiscal multiplier is considerably smaller than many enthusiastic supporters of fiscal stimulus appear to think — including government ministers making large spending announcements.

The basic logic of the fiscal multiplier is simple enough. For example, if the Canadian government increases its military spending by, say, \$10 billion per year, a large fraction of this new spending will represent an increase in demand for domestically produced goods and services. For the recipients of this spending — soldiers and equipment suppliers, for example — the new government spending represents an increase in their incomes. As their incomes rise, most of them will increase their own spending on a wide range of products — food, clothing, entertainment, vacations — and their new spending will then represent new income for a new group of recipients. This process continues, with new spending generating new income, which leads to new spending, which creates new income, with the result being an overall increase in GDP larger than the initial increase in spending that brought it about.

Three things tend to limit the size of the fiscal multiplier, however. First, individuals who experience an increase in income generally must pay some taxes on this new income, thereby reducing the amount available they can spend. Second, even after taxes are paid, most individuals will not increase their spending by the full amount of the increase in after-tax income, choosing instead to save some of these new resources for the future. Third, even once the new spending does occur, some fraction of it will be on imported products, thereby reducing the amount available to increase other Canadians' income. These three factors together lead to estimates of the fiscal multiplier being in the range of 1.0 to 1.5 over the short run. In other words, an increase in government spending of \$10 billion this year will likely lead to an increase in GDP of between \$10 billion and \$15 billion over the next one to three years. In the 2009 federal budget, which introduced a large fiscal stimulus designed to fight the global financial crisis's recessionary impact, Annex 1 provides a concise discussion of how estimates of the fiscal multiplier figured into the design of the government's expansionary fiscal policy (Flaherty 2009).

Canada's defence spending is now slated to increase from today's level of about 1.4 per cent of GDP to five per cent by 2035 (Prime Minister's Office 2025). In today's dollars, this increase amounts to well over \$100 billion of new annual spending. Based on what is known about the fiscal multiplier, we can expect this large increase in military spending to have a noticeable expansionary impact on the economy. Not only will it increase employment and output in the defence-related industries but it will also provide a boost to Canada's overall GDP, especially since it is unlikely that all the increase in defence spending will be financed through cuts in other government spending. But how long will this boost to our annual GDP last? This gets us to the size of the fiscal multiplier in the long run, say four or more years.

Over just a few years, an increase in government spending can boost GDP by a greater amount. The fiscal multiplier is greater than one. If the economy begins in a recessed state, with unemployed workers and idle production facilities, such an expansion in GDP is relatively easy because these idle resources can quickly be put back to work. Even if the economy begins with little or no excess capacity, an increase in government spending can still boost GDP because the economy can operate beyond its potential level, at least for a while. But having GDP above the economy's productive potential eventually leads to increases in wages and other factor prices, which drive up firms' costs. In such an overheated economy, the rising costs lead firms to raise

their prices, which reduces the purchasing power of national income, reduces spending and brings GDP back to its potential level. This natural adjustment process embedded within the economy means that following shocks of various kinds, including increases in government spending, the annual level of GDP tends to return to its potential level. The long-run fiscal multiplier is therefore zero, or very close to it.

That the short-run fiscal multiplier is greater than one while the long-run fiscal multiplier is close to zero leads to two observations. First, the negligible long-run multiplier is not an argument for abandoning the idea of using government spending to stabilize the economy. During a recession, especially a deep one that is expected to persist for several quarters, there is a compelling case for using the government's fiscal powers to stimulate aggregate demand and thereby dampen the recession's worst income-destroying impact. This is especially true since the burden of most recessions is not uniformly felt across the population. Instead, there is generally a small percentage of the labour force whose incomes evaporate as they lose their jobs, while most people retain their jobs and most if not all their income. The impact of recessions on income inequality is therefore usually quite stark. In this context, since the urgency is to address a short-run phenomenon, the fact that the fiscal stimulus's benefits disappear after only a few years is not an argument against using this policy approach.

The second observation relates to the size of the long-run fiscal multiplier: is it actually zero, or merely quite small, and on what does its size depend? The economy's natural adjustment process, described above, means that we can expect GDP to return to its potential level within, say, five years following any change in government spending. But what if the government spending itself has an impact on the economy's long-run productive potential, as would be the case if the new government spending was on productivity-enhancing infrastructure such as highways, bridges, electricity networks, port facilities and the like? In this case, government spending's long-run impact is positive because it led not just to increases in aggregate demand in the short run but more crucially, to the economy's aggregate supply in the long run.

This observation leads to an additional important observation regarding the macro effects of government spending. If the goal of government policy is to address a short-run phenomenon such as a recession, governments can usefully increase their spending on a wide range of things. Governments can target higher salaries for public servants, more spending on road improvements and better recreational facilities in communities. The overall impact will be an increase in GDP that lasts for a few years. But if the goal of government policy is to improve the economy's long-run productive potential, much more attention needs to be placed on the nature of the government spending. To have a sustained increase in GDP resulting from the government's fiscal actions, the new spending must fall on things that genuinely can be expected to improve the country's level of productivity, which typically comes from more and better capital equipment, more innovation, better infrastructure and fewer obstacles to competition. This is much easier said than done.

## GOVERNMENT TRANSFERS

As mentioned above, government transfers are grants from governments to individuals, businesses, organizations and other governments. There is no market transaction involved with a transfer and so GDP is not directly affected. But when taxes are initially levied to raise the revenues, and when the recipient has spent the transferred funds, these actions have their respective influences on GDP. For example, the massive financial transfers from the federal government to individuals during the COVID-19 pandemic, financed not through taxes but through increased government borrowing, did not directly add to Canada's GDP (Government of Canada n.d.).

But as millions of Canadians spent these funds on groceries, rent and other essentials, those market transactions directly affected Canada's GDP and were responsible for moderating the steep economic decline that occurred in the middle of 2020.

Even outside of economic crises, transfers to individuals are an important part of Canada's social safety net and they occur at both federal and provincial levels. Old Age Security (OAS) and the Guaranteed Income Supplement (GIS) are large federal transfer programs aimed at seniors and Employment Insurance (EI) is a large insurance-based federal transfer that provides temporary income relief to unemployed workers. The largest of the provincial transfers is social assistance, commonly referred to as welfare, which are payments made to the lowest income Canadians. Some transfers are universal and made to all individuals, independent of their income, as is the case for OAS (although there is an income-dependent clawback). Others are income-tested and provided only to individuals whose incomes are below a specified level, as with GIS and welfare. There is little debate in Canada about the general need for and value of these kinds of transfers, as there is widespread support among Canadians for having a reliable social safety net. There are debates, however, regarding the extent to which such support payments should be universal versus income-tested. In the face of other priorities and scarce public dollars, it is especially questionable to be providing income support to individuals or families with healthy incomes.

Transfers to businesses invite more debate among Canadians. When the federal government, in response to the policies included in the 2022 U.S. *Inflation Reduction Act* (IRA), provided very generous production subsidies to Canadian producers of electric vehicle (EV) batteries, many viewed this policy as merely one more in a long line of inappropriate corporate welfare (McCaffery and McDonnell 2024). Supporters of these subsidies argued for the need to maintain production and employment in the Canadian auto sector. Opposition to these policies grew in 2025 when China imposed large tariffs on the import of Canadian canola in response to the high Canadian tariffs levied the previous year on Chinese steel, aluminum and EVs. This stoked tensions between Western farmers and Eastern manufacturers — a familiar tension running through decades of Canadian economic history. With Trump's recent elimination of many of the IRA's policies, the wisdom of Canada's matching policies is being further questioned.

Government transfers to non-business organizations often invite a different kind of debate among Canadians. For example, when provincial governments transfer large sums of money to universities — on average just under half of their operating budgets — those Canadians who strongly favour publicly funded education are supportive and many of them would likely approve of even more generous public funding. But many other Canadians believe that university students, who disproportionately come from middle- and upper-income families, are capturing the lion's share of the benefits of their education and should be required to pay more of the tuition fees themselves. On top of this, it is widely recognized that provincial funds are all too scarce, and so greater funding of universities inevitably leads to less money being available for health care, primary education, highways, social assistance and other provincial priorities.

The final category of government transfers — those occurring between different levels of government — is explained by Canada's sophisticated system of fiscal federalism which sets out the division of taxing and spending powers between federal, provincial and municipal governments. Central to this system are transfers from the federal government to provinces and territories, and transfers from those governments to municipalities. Ordinarily, there are few transfers from the federal government directly to municipalities, but in recent years this practice has become more common (often to the dismay of provincial governments). In 2024–25, the federal government transferred just under \$100 billion to the provinces and territories, the largest portion being for social programs, health care and equalization (Government of Canada 2025b).

The Canadian Social Transfer (CST) and the Canadian Health Transfer (CHT) are both made on an equal per capita basis to each province; in the 2024–25 fiscal year, the total payments under CST were \$16.9 billion, while the total payments under CHT were \$52.1 billion. These payments are in principle to be used for various social programs (CST) and for health-care delivery (CHT), but in practice the receiving provinces can use the funds however they choose. The renegotiation of the CHT payments, which happens every few years in discussions between the federal and provincial governments, often generates considerable disagreement. Since health care is by far the most expensive item in provincial budgets, the provinces naturally want more funds from the federal government and strongly prefer no conditions being attached to this funding. In contrast, the federal government typically wants the provinces to take greater financial responsibility for operating their own health-care programs and prefers to attach some conditions to the federal funds provided.

The federal equalization program is based on the underlying logic that Canadians should have roughly comparable access to comparable public goods at comparable tax rates, no matter where they live in Canada. The program therefore makes payments to provinces that have lower fiscal capacities, as determined through a complex formula applied to each province's various tax bases. In 2024–25 the total equalization payments were \$25.3 billion, and these funds can be spent in whatever way the receiving provincial government deems appropriate. Many Canadians criticize the equalization program, especially some who live in the wealthier provinces that do not receive payments, such as Alberta and Saskatchewan. It is often characterized as an inappropriate redistribution from wealthier provinces to poorer ones, one which permits the recipient provinces to continue offering expensive and possibly growth-retarding social programs at the expense of the wealthier provinces. In contrast, many other Canadians view the equalization program as an integral and natural part of an overall progressive tax-and-transfer system, designed to redistribute resources from higher-income to lower-income individuals.

Regarding the impact of transfer payments, most of the attention is on the micro effects of such policies, and these are usually straightforward. For example, seniors in Canada who receive the OAS and/or GIS payments have more after-tax income than they otherwise would have, and as a result, they have command over greater purchasing power. The benefits to them are clear. Workers who receive EI payments while unemployed are obviously able to spend on some necessities while continuing their job search, thereby making them more able to search thoroughly for a job that better suits their skills and interests.

The micro impact of transfers to businesses is also quite clear, although there is some danger involved in extrapolating these benefits to the aggregate economy. For example, production subsidies or other financial support provided to a business will no doubt improve that business's profitability and lead it to employ more workers and produce more output than it would otherwise. Indeed, it would be very surprising if such micro effects did not occur for any firm receiving financial support from the government. But the problem comes when claims are made about the overall job creation benefits of such financial support programs. The extra workers hired by the supported business, especially if they are highly skilled, will generally not come from the pool of unemployed workers but instead will be bid away from other employers. The jobs created at the supported firm will almost certainly exceed, perhaps by a large margin, the total amount of employment created in the economy. Politicians can nevertheless rarely resist the temptation to claim that their financial support programs create many thousands of jobs at the targeted businesses and far beyond.

As for the transfers between levels of government, they are inherently less micro in nature due to the very large sums of money involved. For such transfers, discussions of impact tend to focus on how they influence the underlying policy incentives for the receiving government. For example, if provinces can continue to rely on federal transfers to finance some fraction of their health-care systems, do they have adequate incentives to improve the cost-effectiveness of these systems? Some argue that it would be preferable to have the federal government reduce its taxes, thereby providing fiscal room for the provinces to increase their taxes and use the increased revenue to finance health-care costs. In this way, the provinces would face more pressure to ensure that their own tax systems were better designed to generate the required revenues and those revenues were spent in the best manner possible.

Economists rarely discuss the macro impact of transfers because a world with smaller or fewer transfers would also presumably be a world with lower taxes, and the macro effects of the two changes would be largely offsetting. For example, while we can be quite sure that a less generous OAS program would result in less income and spending by seniors, if the change in the program were matched with an equivalent reduction in income taxes, then some set of Canadians would have more income and could thus afford more spending. In micro terms, the two sets of changes would not be equivalent, as different people would be involved in the changes, but in macro terms the changes to aggregate income and spending may be close to zero.

## BUDGET DEFICITS AND GOVERNMENT DEBT

The foregoing discussion suggests that governments need to think carefully about how to raise their tax revenues. Whom to tax, what to tax and how much to tax all matter for a wide range of economic outcomes, from fairness across families to impacts on employment, investment and long-run growth. Governments must also carefully consider their spending plans, as many micro impacts depend on which products and sectors government spending favours. In macro terms, a great deal rests on how much governments spend, and whether their spending adds to the economy's long-run productive potential. As for transfers, an ongoing debate relates to the desired generosity of the social safety net, and whether the form of government transfers affects the recipients' economic incentives, whether individuals, businesses or other governments.

Left unsaid is that the complexity of fiscal policy is even greater than the many issues involved in taxing, purchasing and transferring. It matters also if there is a gap between total spending and total revenues, and whether that gap is short-lived or persistent enough that government becomes highly indebted over time. We turn now to this issue.

Any government that decides to spend more in a year than it raises in revenues is forced to borrow to make up the shortfall. This borrowing is the government's budget deficit for the year, and it adds to whatever stock of debt already exists, accumulated from past borrowing. For the federal government, 2024's Fall Economic Statement projected a deficit for the 2024-25 fiscal year of just over \$48 billion, meaning that the government's stock of (net) debt would rise by that amount over the course of the year, starting from a base of about \$1.3 trillion (Government of Canada 2024a).

Annual budget deficits and levels of government debt are best considered, not in absolute dollar terms, but relative to the economy's size. A public debt of \$1.3 trillion, which the Canadian government can currently manage, would be trivial in an economy as large as the United States but crippling in one as small as New Zealand. A country's GDP is the simplest measure of its tax

base, which is the foundation of any government's ability to service and repay its debt. Canada's federal deficit in 2024–25 was about 1.6 per cent of GDP while the federal net debt was about 42 per cent of GDP.<sup>3</sup>

That deficits and debt are most usefully expressed in terms of their ratio to GDP leads to two observations. First, the government's deficit today of roughly \$50 billion and now projected to rise to about \$90 billion by the end of this fiscal year, is significantly larger in dollar terms than the deficits of the early 1990s, though it is much smaller as a share of GDP. In 1992–93, the federal deficit was \$39 billion, but this was 5.4 per cent of GDP that year (Government of Canada 2024b). The federal net debt was also much smaller then than today in dollar terms, but the net debt-to-GDP ratio in 1992 was almost 70 per cent. The difference, of course, is that the GDP's dollar value has grown hugely since that time — by roughly four times — both because of real output growth and inflation.

The second observation relates to the debt-to-GDP ratio, which most economists accept as the best overall indication of the government's fiscal prudence. Since this measure is the ratio of the dollar value of outstanding debt to the dollar value of GDP, it follows that this ratio can decline even if the absolute amount of debt continues to rise. For example, if the government operates a deficit, the amount of debt will rise. But if the deficit is small enough that the overall debt rises by a smaller proportion than the rise in GDP, the debt ratio will decline. Indeed, in the almost three decades following the Second World War, when the federal debt-to-GDP ratio fell from over 100 per cent to less than 20 per cent, the absolute level of federal debt continued to rise, but it was rising much less quickly than the economy was growing and so the debt-to-GDP ratio declined sharply. Budget surpluses are required to reduce the absolute amount of debt, but small deficits and healthy economic growth are consistent with a declining debt-to-GDP ratio.

Changes in a government's debt-to-GDP ratio depend on three crucial economic variables. The first is the extent to which the government's program spending exceeds its revenues, leaving aside its debt-service payments; this is the government's primary deficit. Other things being equal, larger primary deficits lead to a rise in the debt ratio. The second and third variables are the interest rate on government debt and the rate of GDP growth. Indeed, the difference between these two rates is crucial. Economists characterize it as  $r - g$ , where  $r$  is the real interest rate on outstanding public debt and  $g$  is the growth rate of real GDP. If  $r$  exceeds  $g$ , then the debt tends to be rising faster than the economy and so the debt ratio rises. In contrast, if  $r$  is less than  $g$ , then the economy is growing fast enough to generate a declining debt ratio, so long as the primary deficit is not too large.

The ultimate policy issue is whether we should care about deficits and the resulting increase in government debt. What are the benefits and costs of government borrowing, and on what do these costs and benefits depend? Why did the Canadian government try so hard to reduce its deficits and the debt-to-GDP ratio in the mid-1990s, whereas the current government appears to be unconcerned about large new spending commitments that will almost certainly push up the deficit and the debt ratio over the next few years? As we will soon see, much depends on the overall context, and especially the existing level of the debt-to-GDP ratio.

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<sup>3</sup> It is common in Canadian policy discussions to focus on the government's net debt, which is the gross amount of outstanding government bonds minus the government's accumulated financial assets, especially those inside the public pension plans such as the CPP and the QPP. Since public pensions in many other countries are not as well funded as those in Canada, the result is that Canada's net debt-to-GDP ratio is low by international comparison, even though our gross debt-to-GDP ratio is much closer to the ratios elsewhere. According to the International Monetary Fund (2025), Canada's gross debt-to-GDP ratio is 113 per cent, that in the United States is 123 per cent and the average among the world's advanced economies is 110 per cent.

The benefits of deficits (and thus of higher public debt) come fundamentally from the tax or spending decisions that create those deficits in the first place. For example, if the deficit increases because of a significant cut in corporate taxes, but the tax cut leads to more investment and higher economic growth, then this benefit must be kept in mind when assessing the wisdom of the higher public debt. For another example, if the deficit is higher because of an increase in defence spending, but such spending is needed to increase Canada's security in an increasingly dangerous and volatile world, then this benefit, which would be difficult to quantify in economic terms, needs to be recognized (Lennox and Lagassé 2025). Of course, in both cases the deficit increase could have been avoided. In the first case, the corporate tax cuts could have been offset with increases in other taxes or reductions in spending, and in the second case the increase in defence spending could have been financed through some higher taxes or reductions in other spending. These decisions would have avoided the deficit's increase, but they would have introduced other fiscal trade-offs.

An increase in the government's deficit that generates benefits with fewer trade-offs occurs when the government increases its spending (or reduces its taxes) to offset the effects of a major recession. During such times, some workers are unemployed and some productive resources are idle, and the economy is therefore operating below its productive potential. The government's fiscal stimulus can help put these resources back to work, thereby increasing employment, output and incomes. The alternative policy — not to provide any fiscal stimulus — would avoid larger deficits but would involve the country suffering an interval of higher unemployment and lower incomes, at least until the economy's adjustment process brings it back to full employment.

The costs associated with larger deficits and higher government debt are more subtle than the benefits, and it is useful to distinguish between periods when the debt-to-GDP ratio is low or moderate and those periods when it is already high. When the government's debt-to-GDP ratio is moderate — as is the case today with the federal debt ratio at about 42 per cent — the impact of larger deficits operates quietly and gradually through interest rates. The government's large-scale demand for credit tends to put upward pressure on interest rates, which then raises the cost of borrowing for the nation's businesses and crowds out private investment. Since the private investment is often in capital equipment or research efforts that spur innovation, the overall effect of this crowding-out is likely to be slower growth in productivity and thus in the long run, growth of Canadians' living standards. These costs are real, but they occur gradually and can go unnoticed for quite some time.

When a government already has a high debt-to-GDP ratio, however, the costs of larger deficits often appear more suddenly and dramatically. In the face of already high debt ratios, creditors who already hold government bonds or are considering buying additional ones often take the prospect of even higher debt as a risky omen. Higher debt, especially when the government has no evident plan to return the debt ratio to lower levels, makes it seem more likely that the government may instead default in some way on a portion of its debt, either through higher inflation or through outright repudiation. The result of such perceived risks is that bondholders are no longer prepared to buy government bonds and may even decide to sell them, with the consequence being a decline in bond prices and a resulting rise in bond yields. If these risks are perceived to be large enough, there will be a sudden rise in interest rates and an exodus from the country's financial assets, thus creating a sudden currency depreciation. This happened in Canada in late 1994 and more dramatically in Greece in 2011. During the short-lived Truss government in the United Kingdom in 2022, reactions to a deficit-laden budget generated the same concerns and almost certainly led to that government's collapse. In France in late 2025, similar concerns are being raised by the attempts of a highly indebted government to cut spending and put the debt ratio on a more sustainable path.

Similar though fewer extreme perceptions appear to be playing out in the United States this year. U.S. government bond yields are rising as the large projected federal deficits are putting the federal (gross) debt-to-GDP ratio on a path that will likely reach 125 per cent by 2034 — well above its level immediately after the end of the Second World War (Bernstein 2025). The days of U.S. government debt being viewed as the ultimate safe-haven asset may be coming to an end. If they are, and if U.S. interest rates continue to rise as a result, it will be difficult for other countries to remain unaffected.

In Canada today, the (net) federal debt ratio is about 42 per cent, well below its level of almost 70 per cent in 1995 when Canada was driven to embark on its spending-reduction and deficit-reduction policies. As Robson, Laurin and Drummond (2025) show in their analysis of the federal government's current finances, even relatively large federal deficits of between two and four per cent of GDP (\$65 to \$130 billion in today's dollars) for the next few years will not push the debt-to-GDP ratio up by more than a few percentage points. Canada's Parliamentary Budget Office (PBO) has concluded that the federal public debt is "sustainable" in the long run, meaning that with the current tax structure and current spending plans, the debt-to-GDP ratio is scheduled to fall rather than increase over the next few decades (Barkova, Cléophat, Creighton et al. 2024).

But in today's economically and politically volatile world, this measure of debt sustainability is not the most useful metric for judging our public debt. In particular, this measure is entirely silent on the possibility that the government may find itself forced to incur large, unplanned expenditures to address a wide range of challenges, from aging-induced demands on health care and the need for the large-scale development of clean electricity to increased defence spending and a greater need to protect our Arctic sovereignty. Any likely but currently unplanned future expenditures are not included in existing measurements of debt sustainability.

The problem today is not that Canada's federal debt is too high, because it is not. The problem is that there appears to be no plan in place to prevent the debt from becoming too high in the near future. What might be called fiscal complacency is a powerful force, with governments deciding on major new spending commitments and then taking the politically easier course of increasing the deficit rather than financing the new spending through either higher taxes or cuts to existing programs. As a result, the debt ratio slowly rises. If interest rates on government bonds continue to rise gradually, as they have over the past few years, and if the GDP's growth rate remains low or even falls further, as may well be the case in the midst of an ongoing tariff war with the United States and China, then  $r - g$  will be rising, thus providing further upward pressure on the debt-to-GDP ratio.

The real danger is that one day we may wake up to find that our debt ratio has once again reached the level where bondholders are reluctant to purchase our government bonds, at which point there will be a sudden spike in bond yields and a depreciation of the Canadian dollar as global investors shy away from our country's financial assets. At that point, as was the case in the mid-1990s, our government will be forced to implement a serious fiscal consolidation — spending cuts and tax increases — at great cost and disruption to the economy. Rather than succumbing to fiscal complacency today and being forced to address such a gloomy scenario in the future, it would be much better to take the time and effort now to make those politically challenging but economically prudent decisions that would enhance Canadians' long-run prosperity.

## QUESTIONS ABOUT FISCAL POLICY

The previous sections have given only a quick introduction to some of the key issues facing the design and implementation of Canadian fiscal policy. Many policy questions continue to interest the economists and policymakers who focus their attention on fiscal policy. Regarding taxation, some leading questions include:

1. After almost 40 years, is it time for a new comprehensive review of our tax system, with a focus on how it can be streamlined and reformed to enhance long-run growth?
2. Do taxes need to be raised to finance the federal government's new spending commitments? If so, which ones?
3. How high can income tax rates get before there are significant negative effects on work and investment, and thus on economic growth?
4. As Canadian governments consider financing a wide range of new expenditures, with some increase in taxation a likely outcome, is there a renewed case for shifting further away from income taxes and toward expenditure-based taxes?
5. To what extent do Canadian taxes — especially corporate taxes — need to mirror those in other countries to maintain the competitiveness of Canada's business sector?

Regarding government spending on either purchases or transfer payments, some leading policy questions include:

1. How can the federal government establish an ongoing process for program review and evaluation to identify ineffective and low-priority programs that can be scaled back or eliminated, thereby freeing up resources for higher priority spending?
2. The Carney government has announced its intention to balance its operating budget while borrowing to finance its capital outlays. It has also indicated that it will redefine capital outlays to include any new incentives that support the formation of private-sector capital or raise productivity. Is such an approach to budgeting practical or does it inevitably lead to politically expedient definitional shifts that permit additional borrowing? See Lester (2025) and Robson, Drummond and Laurin (2025) for some critiques of the government's suggested approach.
3. How can Canada's social safety net be improved to ensure that adequate benefits are provided to those in need but funds are not wasted on those who do not need support? What would be the costs, fiscal and otherwise, of such changes?
4. Should some major federal transfers to provinces, such as the CST and CHT, continue in their current form or should they be replaced with a transfer of tax room in the same direction? Would such a change lead provinces to improve their delivery of health care and other social programs?
5. Should Canadian governments review their current programs offering financial support to businesses and, if so, what guiding principles should be used to justify such support?

Regarding budget deficits and public debt, some leading policy questions are:

1. How high can the debt-to-GDP ratio get before bondholders' perceptions of risk lead to sharp increases in government bond yields?
2. The Carney government has announced its intention to balance its operating budget within a few years but to continue borrowing to finance capital outlays. Do bondholders recognize this distinction and are there limits to how much of this debt can be sold?
3. How can the costs of high government debt be effectively communicated to voters so that it becomes easier for the government to raise taxes or cut spending to prevent the debt-to-GDP ratio from becoming too high?

## FINAL REMARKS

As Canada faces its current and impending challenges, how will our governments respond with their fiscal tools and how large will government become? Spending is already slated to increase significantly on defence and security, but will there also be new spending commitments on trade-related infrastructure, clean energy production, health care or other parts of the social safety net? What will be the scale of the overall increase in spending? Will the benefits of this new spending be our greater security or health, or will we also benefit from higher average incomes? Will new government spending be able to reverse our longstanding problem of slow productivity growth?

How will we pay for this new spending? Will tax rates be increased and, if so, will Canadians judge the new balance of taxes to be fair? Will we depend more on expenditure-based taxes and reap the benefits that come from greater saving and growth, or will we further increase income tax rates and face the problems that come from potentially losing workers and capital to other countries? Another option is that we avoid large tax increases and choose instead to finance new government spending with considerably higher deficits and further increases in our public debt. What are the limits to this financing approach and how can we avoid the negative experiences that highly indebted countries often suffer?

Economic prosperity is not a simple concept and it defies a simple measure. Average income surely matters, but so does the distribution of income across the population. The amount of investment and innovation in both the private and public sectors matters for our longer run economic prospects, but so too does Canadians' ability to learn new skills and attain stable and rewarding careers. Maintaining access to global markets matters, both in terms of our ability to develop and sell our exports to other countries and our ability to import a wide range of products that are better or more cheaply produced elsewhere. Our governments' ability to respond to crises through large-scale spending matters enormously, but this ability relies on a commitment to fiscal prudence that yields relatively low levels of public indebtedness. Finally, in a world that is increasingly volatile and dangerous, our ability to defend ourselves against a wide range of foreign threats matters for Canada's continued prosperity.

Luckily, Canadian fiscal policy is also complex and can be instrumental in promoting the many aspects of our prosperity. Whether considering taxation, government purchases, transfer payments or borrowing, the number of fiscal tools at our disposal is impressive. Each one is designed for a specific purpose and if we tailor them well and implement them carefully, each can achieve its stated objective. The collection of fiscal policy tools can make an enormous difference to Canadians' prosperity.

The challenge is to ensure that we think carefully about the nature and sources of each problem and understand how government policy can best address it. This involves identifying the small number of policy tools best designed to deal with each specific problem and to calibrate those policy tools appropriately. Not every tool is useful to address each problem, and so policymakers must identify the most appropriate assignment of tools to objectives.

Finally, none of this happens automatically. Fiscal policy is a collection of tools governments possess, but they must be designed, analyzed, implemented, reviewed and reformed through policymakers' decisions. This relies on a solid belief that government can be a source of good for society and that Canadian prosperity can be improved through careful policy actions. There is little room here for economic policy nihilism.

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# About the Author

**Christopher Ragan** is an Associate Professor and the founding Director of McGill University's Max Bell School of Public Policy.

Ragan was the Chair of Canada's Ecofiscal Commission, which launched in November 2014 with a 5-year horizon to identify policy options to improve environmental and economic performance in Canada. He was also a member of the federal finance minister's Advisory Council on Economic Growth, which operated from early 2016 to mid 2019. During 2010-12 he was the President of the Ottawa Economics Association. From 2010-13, Ragan held the David Dodge Chair in Monetary Policy at the C.D. Howe Institute, and for many years was a member of the Institute's Monetary Policy Council. In 2009-10, Ragan served as the Clifford Clark Visiting Economist at Finance Canada; in 2004-05 he served as Special Advisor to the Governor of the Bank of Canada.

Chris Ragan's published research focuses mostly on the conduct of macroeconomic policy. His 2004 book, co-edited with William Watson, is called *Is the Debt War Over?* In 2007 he published *A Canadian Priorities Agenda*, co-edited with Jeremy Leonard and France St-Hilaire from the Institute for Research on Public Policy. *The Ecofiscal Commission's The Way Forward* (2015) was awarded the prestigious Doug Purvis Memorial Prize for the best work in Canadian economic policy.

Ragan is an enthusiastic teacher and public communicator. In 2007 he was awarded the Noel Fieldhouse teaching prize at McGill. He is the author of *Economics* (formerly co-authored with Richard Lipsey), which after sixteen editions is still the most widely used introductory economics textbook in Canada. Ragan also writes frequent columns for newspapers, most often in *The Globe and Mail*. He teaches in several MBA and Executive MBA programs, including at McGill, EDHEC in France, and in special courses offered by McKinsey & Company. He gives dozens of public speeches every year.

Ragan received his B.A. (Honours) in economics in 1984 from the University of Victoria and his M.A. in economics from Queen's University in 1985. He then moved to Cambridge, Massachusetts where he completed his Ph.D. in economics at M.I.T. in 1989.

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