

The Tax-Spend Debate:
The Case of Canada

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ABSTRACT

This paper examines the time series relationship between revenues, expenditures, and GDP in the case of Canada. Utilizing the Johansen-Juselius multivariate cointegration procedure and error correction modeling we find that revenues follow a time path independent of expenditures and GDP. On the other hand, expenditures respond to budgetary disequilibrium in that budget imbalances would be corrected by expenditure changes. Moreover, evidence suggests that expenditures also respond to GDP.

of large budget deficits and the growth of debt. The government has taken the approach of cutting government spending more so than raising taxes as a means to solve the budgetary dilemma (Martin, 1996). The task of this paper is to extend the literature on the tax-spend debate to the situation prevailing in Canada.

In order to understand the effectiveness of fiscal policy actions to reduce budget deficits one needs to examine the time series behavior of government revenues and government expenditures and their interdependence. Several hypotheses have been set forth in the discussion of the causal link between revenues and expenditures. The tax-spend hypothesis suggests that changes in revenues induce changes in expenditures. The spend-tax hypothesis suggests the opposite in that changes in expenditures induce changes in revenues. The fiscal synchronization hypothesis suggests that revenue and expenditure decisions are made jointly. Another view relates to the institutional separation of the expenditure and taxation decisions of government. This perspective suggests that revenues and expenditures are independent of one another. Understanding these hypotheses is crucial in gaining further insight on relationship between government spending.