

**PLANNING A CREDIBLE 2010 BUDGET STRATEGY
(The Case For Realism, Responsibility, and Prudence)**

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Most would agree that, with the recession over and the recovery started, albeit slowly, the Minister of Finance should set out a medium-term strategy in his next budget that would support economic growth and eliminate the deficit. But what should such a strategy look like? The strategy the government is proposing is quite simple and politically attractive. The Prime Minister and Minister of Finance have said it many times; they will never raise taxes or cut transfers to provinces or to individuals to balance the budget. Instead, they will rely on economic growth, and if that is not enough, they will cut “other spending programs”. In other words, they will “hope for the best”.

This is a very politically attractive strategy. It doesn't require much from government and it satisfies the views of most Canadians about government. Government spends too much, and most of it wasteful, and in addition, taxes are too high. The fact that both of these assumptions are invalid is irrelevant and doesn't seem to bother anyone. The federal government is smaller as a share of the economy today compared to any time since the World War II, and our federal tax burden is also lower, in almost half a century.

Our fiscal situation today is not nearly as serious as it was in the early 1990s. A structural deficit of 1% of GDP is not a crisis issue. The issue for policy makers is that we take steps to day to prevent it from becoming a crisis issue.

A “hope for the best strategy” to deficit elimination was tried before in the early 1980s and it failed badly. The deficit never went away and government debt rose year after year reaching over \$560 billion, equivalent to a post-war record two-thirds of the economy. By the early 1990s the federal government faced the worst financial crisis since World War II.

For the upcoming budget to have credibility, three questions need to be addressed. First, what is the outlook for the deficit; will it disappear as the stimulus spending is withdrawn and the economy recovers or does the deficit now contain a “structural component” which can only be eliminated through a combination of spending cuts and tax increases? For a budget to be credible, it needs to be based on a *realistic* assessment of its size and components.

A second important question is how should the budget take into account both economic and policy uncertainties? Domestic and global economies will not behave as politicians would like them to, and there will inevitably be both expected and unexpected policy pressures. To be credible, the budget must be *prudent* in allowing for these uncertainties and their potential impact on the budget.

The third and final question is whether the budget should contain resources to reduce the debt that the government is now incurring or should we simply leave it to future generations as was done in most of the post-War period. For a budget strategy to be credible, it must also be *responsible* and include resources to reduce the debt.

What is the Outlook for the Deficit?

Table 1 shows the latest deficit forecasts released by the Department of Finance¹ and the Parliamentary Budget Officer (PBO)². There is very little difference in the economic assumptions underlying the forecasts and, most importantly, the forecast levels of nominal GDP – the applicable tax base for federal revenues - by 2014 are quite similar. This is not surprising as both surveyed the same private sector economists at roughly the same point in time.

The forecasts of budget balances are almost identical to 2011-12. Thereafter they begin to diverge with the Government's deficit declining much more quickly than in the PBO's forecast. In neither forecast is the deficit eliminated over the next five years.

It is important to understand why these fiscal forecasts differ in the outer years, as this can have important implications for budget planning. The PBO made a number of adjustments to the Finance forecast, which we believe were warranted. First, the PBO excluded from the Finance forecast of direct program expenses, the Government's estimate of unidentified expenditure cuts, totaling \$6.4 billion over the six years. There is simply no justification for their inclusion, as there is no plan to secure these savings

¹ *Update of Economic and Fiscal Projections*: Department of Finance September 2009

² *Economic and Fiscal assessment Update*: Office of the Parliamentary Budget Officer November 2, 2009.

Table 1 Comparison of Fiscal Forecasts: Department of Finance and Parliamentary Budget Officer						
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
(Billions of dollars)						
Department of Finance Deficit	-55.9	-45.3	-27.4	-19.4	-11.2	-5.2
PBO Adjustments (1)						
Direct program expenses						
Unidentified savings	-2.0	-1.5	-1.1	-0.6	-0.6	-0.6
Lapse					-1.5	-3.0
Budgetary revenues						
Corporate income taxes	-0.4	-0.5	-2.4	-2.9	-2.9	-2.9
Other revenues	2.0	0.0	-1.3	-2.9	-3.0	-3.0
Other	2.1	4.2	4.3	2.6	0.2	-0.3
Net adjustment	1.7	2.2	-0.5	-3.8	-7.8	-9.8
PBO Deficit (1)	-54.2	-43.1	-27.9	-23.2	-19.0	-15.0
Of which:						
Structural balance	-12.5	-13.5	-13.1	-16.9	-18.9	-20.0
Cyclical balance	-41.8	-29.6	-14.8	-6.5	-0.1	5.0

1. Authors' calculations for 2014-15.

Second, the Department of Finance arbitrarily reduced planned expenses by \$1.5 billion in 2013-14, and \$3.0 billion in 2014-15, which it attributed to a higher expected “lapse” in departmental spending authorities. The PBO correctly argues that this assumed increase in the lapse is “not adequately supported”. An increase in the lapse normally comes about due to the introduction of new spending initiatives, which is not the case in 2013-14. This arbitrary increase in the lapse reduced the growth in direct program expenses to around 2 per cent in both 2013-14 and 2014-15, well below the historical average and well below what would be expected given the nature of the programs included in this component.

Third, on the revenue side of the budget, the PBO has, quite correctly, taken a more prudent forecast of budgetary revenues in the outer years, especially for corporate income taxes and other revenues. This reflects their view that the growth in corporate profits and the application of prior-year losses to taxable income will significantly dampen corporate income taxes over the medium term. With respect to other revenues, the BPO lowered its forecast of revenue resulting from the Insured Mortgage Purchase Program, as the use of the facility has been less than previously anticipated. In addition, the PBO assumes somewhat higher personal income taxes, customs import duties and employment insurance premiums and lower employment insurance benefits. In the first two years of the forecast, these adjustments are largely offsetting, resulting in the PBO forecasting a somewhat lower deficit outcome than the Department of Finance.

Does the Deficit have structural component?

Besides taking a more prudent view in forecasting the budget, the PBO has carefully decomposed the total budget deficit into its structural and cyclical components. What the PBO is trying to do is derive an estimate of what government's expenses and revenues, and the resulting deficit, would be in the absence of the economic cycle. This is a notoriously difficult and judgmental calculation, but one that needs to be done, because of the policy implications that flow from it. The PBO estimates that over the next 5 years the combination of stimulus withdrawal and economic growth will reduce the deficit quite quickly. However, this will be offset by a growing structural deficit, increasing from \$12.5 billion this year to almost \$19 billion, or 1% of GDP, by 2013-14.

What could account for such a large structural deficit?

Since the deficit was eliminated in 1997-98, there have been major changes to the fiscal structure, as shown in Table 2. As a percent of GDP, budgetary revenues declined significantly from 18.2% in 1997-98 to 16.2% in 2005-06. They are forecast to decline even further to 15.0% by 2014-15, the same level as in 1962-63.

	1997-98	2005-06	Change	2014-15	Change
Budgetary revenues	18.2	16.2	-2.0	15.0	-1.2
Program expenses	13.0	12.8	-0.2	13.6	0.8
Public debt charges	4.9	2.5	-2.4	2.2	-0.3
Budgetary Balance	0.3	0.9	0.6	-0.8	-1.7

A major reason for the decline is that both the Liberal and Conservative governments have introduced major tax cuts since the deficit was eliminated. For example, by 2004-05, measures announced in the in the 2000 Budget and the October 2000 Economic Statement and Budget Update provided over \$100 billion of cumulative tax cuts. The cumulative value of all tax reductions introduced by the Conservative government since the 2006 budget could reach over \$100 billion to 2009-10 (see Table 3). Cuts in personal income taxes could total \$52 billion over this period; reductions in corporate taxes \$13 billion; and cuts to the GST and excise taxes close to \$32 billion. In the absence of any change to tax policy, the total loss in revenue of the tax cuts implemented since 2006 could easily grow to over \$300 billion by 2014-15.

A second reason for the declining trend in the revenue share is that potential economic growth is expected to slow over the medium term. Recent studies by the PBO³ and TD Economics⁴ suggest that potential economic growth could slow to 1.6% - 1.9% over the 2009-2014 period, down sharply from potential growth of about 3% per year on average

³ Ibid

⁴ *A New Normal: Canada's Potential Growth During Recovery and Beyond*: TD Economics November 10, 2009

over the past two decades. Such a slowdown in potential growth would seriously restrain the overall growth in government revenues.

Table 3
Fiscal Impact of Measures Announced since the 2006 Budget

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
(billions of dollars)										
A. Revenue Measures										
Personal income tax	5.0	6.6	12.6	11.9	16.0	13.8	14.4	15.0	15.4	15.7
Corporation income tax		1.0	0.9	4.7	6.5	7.1	9.3	12.6	12.9	13.5
GST/sales & excise taxes		3.6	7.4	12.3	12.9	13.5	14.0	14.5	15.1	15.8
Total	5.0	11.2	20.9	28.9	35.4	34.4	37.7	42.1	43.4	45.0
B. Spending Measures										
Economic Action Plan					18.7	10.3	1.1	1.0	1.0	0.6
Other	1.4	2.6	3.2	2.6	21.0	12.4	5.1	4.6	4.6	4.6
Total	1.4	2.6	3.2	2.6	21.0	12.4	5.1	4.6	4.6	4.6
C. Gross Fiscal Impact	6.3	13.8	24.1	31.6	56.4	46.8	42.8	46.8	48.0	49.5

Source: Department of Finance: Budget documents.

There is no doubt that the tax cuts introduced since the 2000 budget, but particularly the 2006 budget, have contributed significantly to the structural deficit that has emerged.

In contrast, program expenses are forecast to increase by less than 1 percentage point, between 2005-06 and 2014-15, primarily reflecting higher elderly benefits, attributable to the growth in the population base and average benefits, which are indexed to inflation, along with increased transfers to other levels of government due to policy decisions and higher defense expenses. Despite this increase, program expenses, as a share of the economy, will remain well below the levels recorded from the early 1960s to the mid 1990s. With public debt charges marginally lower, the budgetary balance deteriorates by 1.7 percentage points from 2005-06, before the recession started, to 2014-15.

Should the Budget Plan Allow for Economic Uncertainties and Policy Pressures?

One certain thing about a medium-term deficit forecast is that it will be wrong, as forecasting is more of an “art” than a science. All forecasters recognize and accept this as fact. This is why the Department of Finance uses the “average” of a group of private sector forecasters, hoping that the “average” somehow has a chance of being close to “right”. It never is. The PBO observes that for 2013-14, the range in deficit forecasts was from a low of \$7.3 billion to a high of \$26 billion. PBO used the “average” “nominal” GDP forecast, which gave a deficit of \$19.0 billion. There is little precision in budget forecasting.

A second certain thing about budget planning is that new policy pressures will emerge that will require funding. Some are already known (e.g., health) but many are unpredictable (e.g. unexpected pandemics). The traditional approach to these “inevitable pressures” is to claim that they can be funded through “program reallocation”. This sounds simple but rest assured in our experience it has never been easy.

Past experience is clear. A credible budget plan must be prudent and include buffers to mitigate the impact of future economic uncertainties and inevitable policy pressures

Should the Budget Plan Allow for Paying Down Debt resulting from the recession and Stimulus Spending

Once the deficit was eliminated in 1997-98, the government began reducing the debt, the first time since the end of the Second World War. Over the following ten years, the federal debt declined by just over \$105 billion, and the debt-to-GDP ratio fell from 68.4 % to just under 30%. The Department of Finance forecast for the period 2008-09 to 2014-15 shows an increase in federal debt of just over \$170 billion, while the PBO forecast, which includes a structural deficit, shows an increase of debt of just under \$190 billion. Even with this increase in debt, the ratio of debt-to-GDP would still remain below 35%; the level recorded in 2005-06. Without policy action, it would take considerable time before the “target “of 25% would be reached (if at all).

Rising debt not only exposes the budget to the impact of higher interest rates, as was the case in the early 1990s, but it also creates an intergenerational shift in tax burden. The question here is whether current generations should contribute to reducing past and current debt rather than leaving it to future generations. We believe such a responsibility exists and that funds should be set-aside explicitly in the budget for debt pay down. These funds could not be used for new spending or tax cuts.

Creating a Credible Budget Strategy

A credible budget would be *realistic* by addressing the structural deficit. It would be *prudent* by including resources to deal with economic uncertainties and inevitable policy pressures and it would be *responsible* by committing to pay down debt.

To illustrate the orders of magnitude that policy makers need to consider, the PBO estimates a structural deficit of about 1% of GDP or \$20 billion by 2014-15. With respect to the inclusion of funds to deal with contingencies, debt repayment, and inevitable policy pressures, 0.5 % of GDP, or \$10 billion, by 2014-15 seems reasonable. In total, a credible budget would need to find about \$30 billion, or 1.5% of GDP, by 2014-15.

Where can this funding be found?

Can significant savings be found from cutting federal program spending? The short answer is no, given that the Government has already ruled out cutting the growth of major transfers to other levels of government and individuals. These exclusions are appropriate given that the budgetary pressures on the provinces for health and education will be substantial, as will pressures on federal transfers to seniors emanating from the ageing of the population. Any reductions to employment insurance benefits would be offset by premium rate changes, thereby having no impact on the budgetary balance.

Table 4 shows the profile of program expenses for 2008-09, as published in the Public Accounts of Canada 2009. Program expenses amounted to \$207.9 billion in 2008-09, of which major transfers to persons and other levels of government accounted for over half. This leaves a base of only \$99.8 billion from which to make expenditure cuts.

But can the government find \$30 billion, or \$20 billion, or even \$10 billion, of savings from this base? To answer this question, it is important to understand what is included in the base.

First, there are a number of programs that need to be excluded from the \$100 billion, due to either legislative provisions or to the fact that the spending is funded through premiums or charges with the result that any reductions in spending would be offset by lower premiums/charges, thereby having no impact on the budgetary balance. For example, the federal government transfers royalties and corporate income taxes that it receives related to offshore activities to Newfoundland and Labrador and Nova Scotia under the Atlantic Canada Revenue Accounts agreements. In 2008-09, this amounted to \$3.5 billion.

Program expenses also include an allowance for bad debts, primarily for uncollectible taxes. For 2008-09, these amounted to \$3.3 billion. The financial statements of the government are presented on a gross basis. As such, they include revenues received by Crown corporations from third parties as well as their related expenses. In 2008-09, these related expenses amounted to \$2.0 billion. Only by raising their revenues from third parties without providing any additional services would there be a positive impact on the budgetary balance and this would affect budgetary revenues not program expenses.

Funding provided to the Canada Housing and Mortgage Corporation (CMHC) is largely under long-term agreements, which would make it extremely difficult to secure any meaningful savings over the medium term. The federal government levies premiums and fees to cover the administration costs for the employment insurance (EI) program and the Canadian Air Transport Security Authority. Any reduction in these costs would be offset by corresponding adjustments to the premium rates/fees. The financial statements of the federal government are presented on an accrual basis of accounting. Capital assets are expensed over their useful life. The amortization costs, therefore, represent the annual costs of the current stock of capital and not the cost of new capital acquisitions. Only if the government were to sell off some of its existing stock of capital assets would the amortization costs be affected.

Table 4	
Program Expenses (\$ millions)	2008-09
September 2009 Update	207,857
Less:	
Major transfers to persons	61,586
Major transfers to other levels of government	46,515
Total	108,101
Potential Base for Cuts	99,756
Exclusions from Base	
Atlantic Offshore Revenue Accounts	3,485
Allowance for bad debts	3,284
Crown corporations: Third party revenues	2,034
Canada Mortgage and Housing Corporation	2,207
EI Administration costs	1,639
Amortization of non-defence capital	1,575
Community, contract & aboriginal policing	1,395
Agriculture: Business Risk Management	1,138
Canadian Air Transport Security Authority	477
Canada Millennium Scholarship Foundation	356
Children's special allowance payments	220
Payments under the Softwood Lumber Products Exports Charge Act	181
Canada Foundation for Innovation	78
Total	18,067
Adjusted Base	81,689
"Sensitive" Program Expenses	
Defence	18,770
First Nations and Inuit programs	7,290
International assistance	3,169
Research agencies	3,007
Infrastructure programs	1,255
Labour market	1,129
Student assistance	423
Homelessness	118
Total	35,162
Potential Base for Cuts	46,527
Of which:	
Personnel costs	26,768
Other	19,759

Source: Public Accounts of Canada 2009

Agriculture and Agri-Food Canada provides assistance to farmers to manage risks and to ensure viable and profitable farming operations. These programs involve participation from producers and provinces and cutting funding would be impossible in the medium term.

The mandate of the Canada Millennium Scholarship Foundation expires on January 1, 2010, such that there are no ongoing savings. Payments to the Canada Foundation for Innovation and various other foundations relate to expenses under previous budget commitments. Cutting these payments would undermine the ability of these foundations to meet their obligations.

The Children's Special Allowance Payments are payments made to agencies and foster parents and are equivalent to the Canada Child Tax Benefit payments, which the Government has indicated they would not cut.

The Softwood Lumber Products Exports Charge is collected by the Canada Revenue Agency on behalf of the provinces. This charge has no impact on the budgetary balance.

In total, these exclusions amount to over \$18 billion, thereby reducing the base for potential spending cuts to just over \$80 billion.

However, even after making these adjustments, there remain a number of programs that would be extremely difficult, if not impossible, to cut. These include defense spending, international assistance programs, programs for First Nations and the Inuit, funding for the various granting councils for scientific, social, and medical research, labor market training agreements with provinces and territories programs, student assistance, and the various infrastructure programs. If these programs, which total just over \$35 billion, are excluded, the base for potential reductions is reduced to about \$46.5 billion.

To find just the \$20 billion of savings required to eliminate the structural deficit would require over a 40% cut in this base. To create a credible budget that would require finding \$30 billion would require a 65% cut. This will not be that easy as over half of this reduced base is the personnel costs of the non-defense departments and agencies. These are the result of collective bargaining, bracket creep, promotions and the introduction of new programs and expansion of existing ones. But without restraining the growth in personnel costs, significant and ongoing savings are simply not achievable.

Some savings can be found from this reduced base, but the experience of the Program Review process adopted by the Liberal government in 1994 teaches two important lessons. First, across the board spending cuts is not an effective way to effectively reduce government spending. Rather, individual programs have to be evaluated in terms of effectiveness, efficiency, and legitimacy. Second, such an intensive review, although necessary, will not even come close to yielding the amount of savings needed

to eliminate the structural deficit or allow for contingencies, policy pressures and debt repayment. A 5 per cent reduction to the base identified above would be realistic but would yield under \$2.5 billion in annual savings.

Politicians and Canadians may not like it but a credible budget will require that taxes be raised. The question is which ones? As a matter of principle, one should look at tax changes that favor economic growth; in other words the balance should favor less tax on income and savings and greater reliance on consumption taxes.

As an example, a phased increase of 2 points in the GST would eliminate most of the structural deficit. This seems fitting since the reductions in the GST were probably the main cause of the structural deficit. One could even consider an additional point increase in the GST with the goal of using the revenue to lower the middle-income tax rate. This could be combined with an increase in the high income tax rate. This would result in a more progressive income tax system and a tax balance more supportive of economic growth.

In addition, one would also want to look at the corporate tax rate, by freezing the current rate at 18%. At the present time, corporations have substantial loss carry forwards to off set taxes. As well, Canada already has a lower tax rate than in the U.S. and it is highly unlikely that the U.S. will be lowering their corporate rates in the near term. In addition, a number of “special interest” tax credits have been introduced since the 2006 Budget and these should be re-evaluated for their effectiveness.

Table 5 sets out an illustrative credible budget strategy with a 2 pt phased increase in the GST. All of these policy actions could be delayed for a later start should the strength of the recovery remain muted. Table 6 provides a summary statement of transactions.

What does this budget achieve?

This budget would be *realistic*. It would eliminate the structural deficit by 2012-23: It would be *prudent* and include reserves to allow for economic contingencies and policy pressures and it would be *responsible* by preventing the future buildup of debt while paying down past debt. The debt burden would actually decline to close to the target of 25% of GDP. Program spending and federal tax revenues, as a share of the economy, would continue to be well below historical averages.

Table 5		Proposed 2010 Budget					
		2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
(Billions of dollars)							
A. PBO November Deficit Track							
1. Structural balance		-12.5	-13.5	-13.1	-16.9	-18.9	-20.0
2. Cyclical balance		-41.8	-29.6	-14.8	-6.5	-0.1	5.0
3. Total		<u>-54.2</u>	<u>-43.1</u>	<u>-27.9</u>	<u>-23.2</u>	<u>-19.0</u>	<u>-15.0</u>
B. Source of Funds							
1. Reduction in program expenses			0.5	1.0	1.5	2.0	3.0
2. Revenue Measures							
1-percentage point increase in GST			1.7	6.8	7.2	7.6	8.0
1-percentage point increase in GST				1.7	6.8	7.2	7.6
Freeze general CIT rate at 18%				0.8	5.3	5.5	5.8
Other revenue-raising measures				1.3	5.3	5.4	5.5
Interest savings				0.2	1.0	2.4	3.8
3. Total fiscal actions			<u>2.2</u>	<u>11.9</u>	<u>27.0</u>	<u>30.1</u>	<u>33.7</u>
C. Use of Funds							
1. Debt repayment reserve			2.2	11.9	16.9	18.9	20.0
2. Prudence reserve					10.1	11.2	13.7
3. Total			<u>2.2</u>	<u>11.9</u>	<u>27.0</u>	<u>30.1</u>	<u>33.7</u>

Table 6		Summary Statement of Transactions: With Proposed Actions						
		Actual						
		2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
(Billions of dollars)								
Budgetary Transactions								
Budgetary Revenues		233.1	219.7	235.8	261.3	289.6	306.4	320.9
Total expenses								
Program expenses		-207.9	-242.8	-244.5	-240.5	-246.2	-255.1	-263.4
Public debt charges		-31.0	-31.1	-32.2	-36.7	-39.6	-40.2	-38.7
Total expenses		<u>-238.9</u>	<u>-273.9</u>	<u>-276.7</u>	<u>-277.2</u>	<u>-285.8</u>	<u>-295.3</u>	<u>-302.1</u>
Budgetary balance		-5.8	-54.2	-40.9	-16.0	3.8	11.1	18.7
Federal debt		463.7	517.9	558.8	574.8	571.0	559.9	541.2
Per Cent of GDP								
Budgetary revenues		14.6	14.4	14.8	15.6	16.3	16.4	16.4
Program expenses		13.0	15.9	15.4	14.3	13.9	13.7	13.4
Public debt charges		1.9	2.0	2.0	2.2	2.2	2.2	2.0
Total expenditures		14.9	17.9	17.4	16.5	16.1	15.8	15.4
Surplus/deficit		-0.4	-3.5	-2.6	-1.0	0.2	0.6	1.0
Federal debt		29.0	33.9	35.2	34.3	32.2	30.0	27.6

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