



Alternative Federal Budget 2004

Alternative Federal Budget 2004 Technical Paper #4

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Crying Wolf Again? A Pre-Budget Assessment of Federal Finances

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"Yes, but the critics argue, you always cry wolf. You say the situation is very tight every year, with no room to manoeuvre, and then when the books are finally closed - surprise, surprise - there are several extra billions of dollars that we didn't expect that just automatically go against the debt. I understand that frustration. Indeed, I have expressed it myself in my previous roles around the Cabinet table."

—Speech by the Honourable Ralph Goodale, Minister of Finance, to the Regina & District Chamber of Commerce at the launch of pre-budget consultations for 2004 Regina, Saskatchewan

Crying Wolf Again? Federal Projections of this Year's Budget Surplus

Prior to the release of the 2004 federal budget, speculation has been intense about the current state of federal finances. While many observers—from all political stripes—contend that Ottawa is sitting on a sizeable budget surplus, Finance Minister Ralph Goodale cautions Canadians to diminish their expectations in light of strained federal coffers.

The speculation concerning the size of the federal budget surplus has taken on new sig-

nificance this year. The Chrétien government promised to support health care with a \$2 billion transfer to provinces and territories provided that the federal budget surplus can cover it. The current Finance Minister has estimated that the federal surplus is \$2.3 billion, leaving the federal government with only a scant \$300 million in excess of the amount that has been contingently promised to support health care. With such a small margin of error, Canadians have been warned of the necessity of cost-saving measures so that the government can make good on their health care offer.

But how credible is this claim of tight federal finances? Is the federal government crying wolf again, or should we believe them this time?

The Government's Track Record On Estimating The Federal Budget Surplus

Federal government watchers are by now keenly aware of the government's abysmal record of forecasting its own surplus. Every year since the elimination of the federal budget deficit in 1997, finance ministers have low-balled their estimates of the federal surplus. But once the fiscal year ends, they disclose



Table 1
Forecast and Actual Federal Budget Balances 1999/2000 through 2002/03¹
(billions of dollars)

| | Official Budget Target ² | AFB Estimate ³ | Actual |
|---------|--|------------------------------|--------|
| 1999-00 | 3.0 | 16.0 | 12.7 |
| 2000-01 | 3.0 | 15.5 | 18.1 |
| 2001-02 | 1.5 | 8.5 | 8.9 |
| 2002-03 | 3.0 | 6.7 | 7.0 |
| Total | 10.5 | 46.7 | 46.7 |

¹ Prior to fiscal year 2002-03, estimates were not made in terms that reflected full accrual accounting measures. As of October 2003, the government has provided fiscal reference tables that restate previous numbers in full accrual terms. However, Table 1 presents the pre-accrual numbers for years prior to 2002-03 in order to compare the government's estimates with AFB estimates for those years. For years 2002/03 and beyond, all numbers are expressed in full accrual terms.

² Equal to balance of "budget for planning purposes", excluding contingency reserve fund, from each annual federal budget.

³ Estimates of status-quo federal surplus reported in *Vital Measures: Alternative Federal Budget 1999* (February 1999); *Reality Check: An Alternative Economic Update* (October 2000); *Alternative Federal Budget Economic and Fiscal Statement* (December 2001); and *The Cure for the Common Budget* (February 2003), respectively.

that they are sitting on a much larger surplus that they had previously divulged.

For years now, the Alternative Federal Budget (AFB), coordinated by the Canadian Centre for Policy Alternatives, has consistently delivered a much more accurate estimate of the budget surplus than has the Finance Minister (*see Table 1*). In this paper, these same methods are applied to assess the situation of federal finances as we approach the release of the 2004 Budget.

Macroeconomic Variables: Adopting the Federal Government's Own Assumptions

Wherever possible, this analysis of the federal budget adopts the same macroeconomic assumptions that the federal government employs. *Thus the difference in federal projections and our projections cannot be attributed to the*

use of any overly optimistic macroeconomic assumptions in our projections.

We adopt the federal government's estimates for GDP inflation, as they are presented in its Economic and Fiscal Update (EFU) of November, 2003. However, the Finance Minister has recently stated that the EFU's forecast for real GDP growth in 2003 of 1.9% has fallen to 1.6% since the publication of the EFU.¹ This reduction in forecasted real GDP growth is used as one of the justifications for the Martin government's claim that the 2003/04 federal budget surplus is a mere \$2.3 billion. Following the Finance Minister, we adopt the assumption of a 1.6% real GDP growth rate.

We replicate the government's own assumptions concerning interest rates by adopting the EFU's estimate that the cost of servicing the public debt will be \$36.2 billion in the current fiscal year.²



Federal Government Revenue and Expenditure: Where We Differ from the Analysis Presented in the Federal Government's "Economic and Fiscal Update"

With the preceding macroeconomic assumptions in place, the second step of the AFB process is to create the most accurate picture possible of the existing state of federal finances. We do this by estimating the "status quo" situation of federal finances—the status of the federal finances in the absence of any significant tax or spending changes. Thus last minute tax or spending announcements are not reflected in the AFB's calculations.

While the AFB adheres closely to the government's macroeconomic assumptions, we do differ in our fiscal projections. Given the government's record of inaccuracy in estimating its budget surpluses year after year, we are forced to engage in some numerical detective work to arrive at a budgetary outlook that is a more accurate reflection of the true state of federal finances. In particular, we depart from the financial information published in the government's 2003 EFU in the estimate of both tax revenues and program spending.

1) Tax Revenue

The federal government projects that budget revenues will drop precipitously as a share of GDP. Whereas in 2002/03 revenues constituted 15.4% of GDP, the EFU projects that in 2003/04 this will fall to 14.8%. This is an enormous drop: revenues as a percentage of GDP have not sunk as low as 14.8% since 1966/67.

Given that the major provisions associated with the 2000 tax cuts are already in place,

the AFB finds such a sharp drop in government revenue share implausible. In the past the federal government has concealed the funds at its disposal by low-balling revenue estimates,³ and we believe that this tactic is being used once again. However, since some tax and other measures are scheduled to come on-stream this year (such as the changes to capital tax), we concede that the government revenue share *may* decrease somewhat. It is impossible to determine how much of the decline in tax revenues predicted by the government is a legitimate reflection of these changes, and how much is the result of government low-balling.

To handle this issue, the AFB estimates that the government revenue/GDP will be 15.1%, or \$183.6 billion. This estimate is roughly mid-way between the pessimistic government forecasts of \$180.5 billion (14.8% of GDP) and the \$187 billion (15.4% of GDP) that would be raised if government revenue continued to be collected at the same share of GDP as in 2002/03. This decline is not inevitable. By employing the preceding assumption we are merely attempting to err on the side of caution by allowing for a substantial decline in tax revenue as a share of GDP.

2) Program Spending

Program spending is the second area in which the AFB's status quo forecast differs from that of the federal government. The federal government's projected program expenses are \$142.05 billion for 2003/04 (*Table 3.8 EFU*), which constitutes a program spending/GDP ratio of 11.7%. This represents a 6.55% increase in program spending over the 2002/03 levels.

A more detailed examination of the federal government's own description of program



Table 2
Estimates of Program Spending, 2002/03

| (fiscal Years/ \$billion) | 2002/03* ACTUAL | 2003/04* ESTIMATE | percentage change** | AFB | |
|---|--------------------|----------------------|------------------------|-----------------------|------------------------|
| | | | | 2003/04** ESTIMATE | percentage change** |
| TRANSFERS TO PERSONS | | | | | |
| Elderly Benefits | 25.692 | 27.015 | 5.1% | 27.015 | 5.1% |
| Employment Insurance Benefits | 14.496 | 15.450 | 6.6% | 15.450 | 6.6% |
| TOTAL | 40.188 | 42.465 | 5.7% | 42.465 | 5.7% |
| TRANSFERS TO OTHER LEVELS OF GOVERNMENT | | | | | |
| Transfers in support of health and other programs | 22.6 | 20.300 | -10.2% | 20.300 | -10.2% |
| Equalization and other fiscal arrangements (net) | 8.045 | 8.585 | 6.7% | 8.585 | 6.7% |
| Total | 30.645 | 28.885 | -5.7% | 28.885 | -5.7% |
| OTHER PROGRAM EXPENSES | 62.49 | 70.700 | 13.1% | 67.785 | 8.5% |
| NET PROGRAM EXPENSES | 133.323 | 142.050 | 6.5% | 139.135 | 4.4% |

Sources :

* EFU 2003, table 3.8

** Author's calculations

spending raises suspicions that the government may be inflating its program spending estimates as an additional way of introducing some behind-the-scenes “padding” into the budget.

To ascertain how much padding is going on, we examined Table 3.8 of the EFU. The relevant sections of Table 3.8 of the EFU are reproduced in Table 3. Table 3.8 in the EFU breaks program spending down into its three major component parts: “Transfers To Persons,”⁵ “Major Transfers To Other Levels Of Government,”⁶ and “Other Program Expenses.”⁷ Table 3 shows the government’s assessment of the increases in these program spending categories, alongside the AFB’s assessment.

According to the EFU, the government claims that “Transfers To Persons” increases by close to 6% to \$42.465 billion “Major Transfers To Other Levels Of Government” *declines* by close to 6% to \$28.885 billion—solely as a result of a drop of more than 10% in transfers to health and other programs. This \$2.3 billion drop is, interestingly, quite close

to the \$2 billion that provinces and territories may receive if the government deems that the current year’s fiscal surplus can accommodate it. For the purpose of creating our estimate of program spending, the AFB accepts these figures as stated.

However, we differ from the government in the final category, namely “Other Program Expenses.” The EFU estimates that this category increases by more than 13%, to \$70.7 billion. Given recent government pronouncements on the importance of fiscal restraint, the AFB regards a 13% jump in this category as an implausibly large increase.

To derive a more plausible estimate for “Other Programs Spending” we employed the following method. We took the 2002/03 totals for this category and adjusted it upwards by 2% to account for increases due to inflation. To this we added new spending initiatives announced in the February budget of **\$2.9 billion** (Table A1.2, Budget Plan 2003) and new spending related to SARS, mad cow disease and other extraordinary items announced since the February 2003 budget of



\$1.14 billion (Table 3.4, EFU).⁷ In this manner, we derive an 8.5% increase (to \$ 67.785 billion) in this category of program spending.

Using the governments estimates of its spending on “transfers to persons” and “major transfers to other levels of government,” and using our estimate for the remainder of program spending, we derive an estimate for total program spending of \$139.1 billion, which constitutes a program spending-to-GDP ratio of 11.4%. Thus, we project that the federal government will *underspend* its own program spending EFU projections by \$2.9 billion.

To the untrained eye, the discrepancy between the government’s claim that it will spend \$142 billion (11.7% of GDP) and the AFB’s claim that federal spending will amount to \$139.1 billion (11.4% of GDP) may seem a bit of a leap. To put this into context, how-

ever, recall the performance of the federal government in fiscal year 2002/03, when the federal government *underspent* its projected program spending totals by over \$5 billion. To great fanfare, it declared a program spending goal of 12.2% of GDP (or \$138.6 billion) in the February 18 2003 budget. Its actual program expenses in 2002/03: \$133.2 billion, or 11.5% of GDP. This shortfall of over \$5 billion dollars in program spending helps to explain the \$7 billion surplus posted by the federal government in the last fiscal year.

The Current Budget Surplus: Did Someone Cry Wolf?

On the basis of the preceding methodology, Table 3 presents our estimate of the 2003/04 surplus.

Table 3
The AFB's Estimates of Federal Finances in 2003/04

| | 2001-02 ACTUALS | 2002-03 ACTUALS | 2003-04 AFB ESTIMATE |
|--|--------------------|--------------------|-------------------------|
| Revenue | 171.7 | 177.6 | 183.6 |
| Program spending | 125 | 133.3 | 139.1 |
| Debt Service Expense | 39.7 | 37.3 | 36.2 |
| <u>BUDGET BALANCE</u> | 7.0 | 7.0 | 8.3 |
| <u>FEDERAL DEBT*</u> | 517.6 | 510.6 | 510.6 |
| <u>MACROECONOMIC INDICATORS (Calendar years)</u> | | | |
| | 2001 | 2002 | 2003 |
| Real GDP Growth | | | 1.6% |
| Nominal GDP growth | | | 4.90% |
| <u>BUDGETARY INDICATORS AS % OF GDP</u> | | | |
| Rev/GDP | 15.5% | 15.4% | 15.1% |
| Program Spending/GDP | 11.3% | 11.5% | 11.4% |
| Debt Service/GDP | 3.6% | 3.2% | 3.0% |
| Total debt/GDP | 46.7% | 44.1% | 42.0% |

accrual method of accounts used, all dollar amounts in Billions.

Notes:

* In 2003/04, Federal debt is held constant at 2002/03 levels



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Based on these assumptions, the AFB foresees a budget surplus of \$ 8.3 billion for 2003/04. This amount dwarfs the \$2.3 billion forecast by the Martin government.

We believe that the government has overestimated program spending by \$2.9 billion while underestimating revenues by \$3.1 billion. To arrive at the AFB's surplus estimate simply do the math: the government's surplus estimate (\$2.3 billion) + spending overestimation (\$2.9 billion) + revenue underestimation (\$3.1 billion) = AFB surplus (\$8.3 billion).

According to this estimate, accommodating \$2 billion transfer in support of health care should be no problem. We emphasize that the transfer should be made with the appropriate accountability mechanisms as recommended by the Romanow Commission.

Table 3 also illustrates that the declining burden of the federal debt, even in the absence of any debt repayment. If the \$8.3 billion surplus were directed towards spending on the programs Canadians need, rather than on debt repayment, the debt/GDP ratio would still decline.

Even with \$2 billion transferred to support health care, the federal government can still afford to be generous in its spending on

other priorities. Canadians need not be discouraged by cries of wolf. As has been the case in previous years, the federal cupboard is far from bare.

Endnotes

- ¹ For example, see the Speech by the Honourable Ralph Goodale, Minister of Finance, to the Regina & District Chamber of Commerce at the launch of pre-budget consultations for 2004, Monday, January 12, 2004 2004-002
- ² See EFU, Table 3.6
- ³ See Jim Stanford, *Paul Martin, The Deficit and the Debt: Taking Another Look* Alternative Federal Budget Technical Paper #1, Canadian Centre for Policy Alternatives. November 2003.
- ⁴ Transfers to persons consist of elderly benefits and employment insurance benefits.
- ⁵ Major Transfers to other levels of government" includes federal transfers in support of health and other programs and equalization payments.
- ⁶ Other program expenses are not broken down in the EFU.
- ⁷ To derive the "other program spending" related components of both the spending Initiatives announced in the February budget and those announced since the February budget, any amounts related to employment insurance and transfers in support of health and other programs have been excluded in our calculations, since these amounts are properly placed in the categories "transfers to persons" or "transfers to other levels of government".



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