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CANADIAN CENTRE
for POLICY ALTERNATIVES

CENTRE CANADIEN
de POLITIQUES ALTERNATIVES

October 2005

Federal Fiscal Forecasting Report

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**For the House of Commons
Standing Committee on Finance**



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Introduction

The Canadian Centre for Policy Alternatives has prepared this report for the House of Commons Standing Committee on Finance on the present fiscal outlook for the government for the fiscal years 2005/06, 2006/07 and 2007/08. This report is one of the four independent forecasts of the federal public accounts commissioned each quarter by the House of Commons Standing Committee on Finance Committee.

The report is divided into three sections. Section one provides a discussion of recent developments on the expenditure side of the federal budget that have an important impact on federal fiscal forecasting. Section two presents the current macroeconomic outlook for the Canadian economy. Based on this macroeconomic outlook, section three sets out our projections of the revenues, expenses and budgetary surplus of the federal government for the fiscal years 2005/06, 2006/07 and 2007/08. Both sections two and three compare CCPA's current forecast with both

the forecast presented in the federal government's 2005 Budget and the CCPA forecast presented in July 2005. Noteworthy assumptions or methodological issues are highlighted in the relevant section.

The Canadian Centre for Policy Alternatives has received assistance in the preparation of this report from Informetrica, a private company specializing in modeling the reaction of the economy to budgetary decisions and other initiatives. Specifically, Informetrica has been involved in providing macro-economic forecasting, and in refining our perspective on the ways in which corporate income tax revenues will be affected by such important factors as the recent rise in oil prices and the high value of the Canadian dollar vis à vis its US counterpart.

The Canadian Centre for Policy Alternatives has prepared this report based on economic information and announced taxation and expenditure decisions as of October 7, 2005.

1 Expenditure Developments of Note for Federal Fiscal Forecasting

The exercise in fiscal forecasting commissioned by the House of Commons Standing Committee on Finance occurs in a context in which the accuracy of the government's federal fiscal forecast is a subject of considerable controversy. For many years, the Finance Department has been criticized for providing fiscal forecasts that underestimated the size of forthcoming budget surpluses. Fiscal year 2004/05 would appear on the surface to be a departure from that pattern, given that the year-end surplus was a relatively modest \$1.6 billion—an amount less than the Government's customary contingency reserve of \$3 billion.

The 2004/05 surplus was modest in large part because of the treatment of several large expenditure items. Five expenditure items with multiple-year spending implications (the Wait Time Reduction Fund, Offshore Revenues Accords, Atomic Energy of Canada Limited's environmental liabilities, and certain expenditures for early learning and child care and medical equipment) were expensed against the 2004/05 fiscal year. Because these expenses totaled over \$10 billion, the decision to expense these items in fiscal year 2004/05 produced a much lower surplus than would have been the case had these items been expensed over several years.

Budget 2005 provided no indication that two of these five items (\$2.3 billion related to Atomic Energy of Canada Limited's environmental li-

abilities and \$2.8 billion for Offshore Revenues Accords) would be dealt with in this manner. In the 2005 Budget document, costs associated with offshore revenue agreements were spread over several years. These costs are now recorded as a one-time lump sum in 2004/05. Budget 2005 gave no indication of any impending budgetary impact of Atomic Energy of Canada Limited's environmental liabilities. If the government had not charged these two expenses against the 2004/05 fiscal year, the budgetary surplus would have been over \$6.5 billion.¹

The three other future expenses charged against the 2004/05 fiscal year (\$4.3 billion for Wait Time Reduction Fund, \$700 million for early learning and child care and \$500 million for medical equipment) were discussed in the 2005 Budget. However, they do raise the longstanding accountability issues posed by funding future expenses out of current surpluses via the use of third party trusts.

As Table 1 indicates, if none of these expenditure items had been charged against the 2004/05 fiscal year, the 2004/05 surplus would have been \$12 billion.

The reduction of a large budget surplus to a modest \$1.6 billion via this pre-payment of future expenditures may create the superficial impression that the Department of Finance is repairing its longstanding record of low-balling budget sur-

plus forecasts. On the contrary — this treatment of expenditures in the 2004/05 fiscal year intensifies our concerns about the accuracy and transparency of fiscal forecasts.

Specifically:

1. To what extent does the Finance Minister exercise discretion about the timing of revenues and expenditures? This is important since areas in which discretion are exercised create the opportunity to manipulate these items to engineer a higher or lower budget surplus. If the Finance Minister selectively adjusts the timing of expenditures and revenues to engineer a desired budget surplus figure, the public's ability to rely on the official forecasts to provide some meaningful perspective on the government's financial position is compromised.

2. Is the Finance Minister promptly disclosing any decisions to change the years in which revenues or expenditures are booked? For example, the government maintains that its change in the treatment of the Offshore Revenue Agreement was the result of a "surprise" determination made by the Office of the Auditor General this past summer. The Finance Department should be required to immediately notify the public of changes in accounting practices that materially impact the federal budget.

These questions are particularly important if major program commitments or tax changes have been made contingent on the size of the budget surplus. For example, Bill C-48 (the spending negotiated with the NDP in the spring of 2005) will occur only so long as the government posts a \$2 billion budget surplus in 2005/06 and 2006/07. The Finance Minister could avoid implementing the spending mandated in Bill C-48 if he is able to adjust the budget surplus via the selective manipulation of expenditures and revenues across various fiscal years.

TABLE 1 Analyzing The 2004/05 Budget Surplus

(\$Billions)	
Official 2004/05 surplus	1.6
Plus Unanticipated Expenditures	
Atomic Energy of Canada Limited	2.3
Offshore Revenue Agreements *	2.6
Total 2004/05 Budget Surplus Prior to Unanticipated Expenditures	6.5
Plus Trust Funds Disclosed in 2005 Federal Budget	
Wait Time Reduction	4.3
Early Learning and Child Care	0.7
Medical Equipment	0.5
Total 2004/05 Budget Surplus Excluding Trust Funds and Unanticipated Expenditures	12.0

*net of Offshore Revenue Agreement expenses that appear in the 2004/05 budget year as of the government's 2005 budget

While Bill-C48 was arguably an unusual arrangement borne of a very specific political circumstance, there are indications that the Liberal government wishes to move in the direction of making more budgetary decisions explicitly contingent on the size of the budget surplus. The proposed budget surplus allocation act marks a further step in this direction. It would require that future budget surpluses be divided equally between debt repayment, spending and reductions in personal income tax.

There are a number of objectionable features of this apparent trend toward the contingent allocation of budget surpluses. Predetermined formulas that are binding once the budget surplus hits a certain magnitude muddle the budgetary process. Some spending and taxation measures are handled via our traditional process for democratic debates within Parliament. Other spending and taxation decisions are driven by a formula that is debated only once in Parliament, and implemented for years to come regardless of the

economic circumstances or changing democratically determined priorities in the future.

This trend toward the contingent allocation of surpluses will inevitably increase pressure to bring political considerations to bear on government bookkeeping. The Finance Minister needs only to find some accounting wizardry to manipulate the size of the budget surplus should he wish to either honour or avoid implementing these contingent decisions. Thus by increasing the incentives for politically-inspired manipulation of the federal finances, federal financial transparency will be further undermined.

As financial transparency is compromised, civil society is less able to monitor and respond to such manipulation. Independent forecasters are always working at a disadvantage because they are not privy to the full range of economic information available to Finance Department insiders. This disadvantage is compounded immensely when decisions that dramatically change the timing of expenditures and revenues are taken for political reasons. Moreover, if the Finance Depart-

ment does not promptly disclose these changes to the public, independent fiscal forecasters cannot make a meaningful assessment of the true status of the government's finances.

At a minimum, the Finance Department should be obliged to make public immediately any departure from its previous public statements on the timing of large revenues and expenditures.

However, at best this solution will only narrow the disadvantage at which independent forecasters work. This dilemma points to the advisability of establishing an entity within government that has access to the full range of information known to the Finance Department, but which is not subject to the same political pressures that have compelled the government to provide such implausible estimates of its forthcoming surplus. Establishing an independent body to provide objective and unbiased forecasts of the nation's finances — and of budgetary proposals — would be the best way of increasing transparency and accountability in the budget process.

2 Macroeconomic Forecast

In previous reports to the Finance Committee, the CCPA generated a forecast of macroeconomic variables by consulting several published forecasts. We have now formalized that process, using the consensus forecast published by Informetrica to provide estimates of macroeconomic variables. In addition, we use the estimates of future oil prices and Canadian dollar exchange rates generated by Informetrica's proprietary model.

Table 2 presents our forecast of key macroeconomic indicators. The numbers are expressed in calendar years, a practice CCPA adopted in its last report to enhance the comparability of its results with other forecasts.²

The macroeconomic outlook for Canada remains good despite the recent hurricanes in the United States and concerns regarding high oil prices. The reaction of the markets for crude oil, gasoline and natural gas to Hurricanes Katrina and Rita have produced short-term hikes in the price of oil. Both the hike in oil prices and the destruction of productive capacity brought about by the hurricanes should have a negative impact on the US economy in the short-run, though this will be dampened by the expansionary stance of US fiscal policy and the boost produced by the reconstruction efforts. However, the negative effects of the hurricanes on the economy should not be overstated, since the two most affected states,

Louisiana and Mississippi, account only for a small portion of total US output.

High oil and natural gas prices have divergent effects on the Canadian economy. Since Canada is a net exporter of oil and natural gas, high prices exert upward pressure on the exchange rate and strengthen Canada's terms of trade. While this is unequivocally positive for the Canadian oil and gas industry, the manufacturing sector suffers both from an increase in the cost of its energy inputs and from the detrimental impact on exporters of a high exchange rate. At the same time, the strong Canadian dollar reduces the cost of imported capital goods on which the manufacturing industry relies to a great extent. On the whole, we expect that the overall impact of high oil prices to be mildly positive on the macroeconomic variables that impact the federal fiscal forecast, although it should be acknowledged that high oil prices certainly impact different regions and industrial sectors in very different ways.

Overall, we expect that nominal GDP growth will average 5.2% per year this year and next, although is expected to slow by 2007. Real GDP is forecast at 2.9% in 2005, rising to 3.1% in 2006 before returning to 2.9% in 2007. The unemployment rate is expected to remain at 6.9% in 2006 and decrease slightly by 2007.

With respect to inflation, there is no strong indication that the Bank of Canada's measure of

TABLE 2 Macroeconomic Forecast

Levels	2004 (actual)	2005	2006	2007
Real GDP (\$mns)	1,124,428	1,157,036	1,192,905	1,227,287
Nominal GDP (\$mns)	1,290,185	1,357,275	1,427,853	1,497,565
3-month Treasury Bill Rate	2.2	2.6	3.5	4.0
10-Year Govt Bond Rate	4.6	4.1	4.6	5.2
Unemployment Rate	7.2	6.9	6.9	6.7
Employment (ooos)	15,959	16,183	16,409	16,621
US Real GDP (\$bns)	10,842	11,221	11,591	11,960
Oil Price \$US/barrel	36.0	46.2	46.3	42.0
Exchange Rate \$(Can/US)	0.77	0.82	0.83	0.84
Per cent change				
Real GDP growth	2.9	2.9	3.1	2.9
GDP deflator inflation	3.1	2.3	2.1	2.0
Nominal GDP growth	6.1	5.2	5.2	4.9
3-month Treasury Bill Rate*	-0.7	0.4	0.9	0.5
10-Year Govt Bond Rate*	-0.2	-0.5	0.5	0.6
Unemployment Rate*	-0.4	-0.3	0.0	-0.2
Employment Growth	1.9	1.4	1.4	1.3
US Real GDP growth	4.2	3.5	3.3	3.2
Oil Price \$US/barrel	29.2	28.3	0.2	-9.2
Exchange Rate \$(Can/US)	7.7	6.9	1.2	1.3

SOURCE Informetrica

* Level change

core inflation is accelerating. In fact, the high value of the dollar will put downward pressure on domestic demand by cheapening imports, which will dampen inflationary tendencies.

Nevertheless, we expect the Bank of Canada to view the sustained growth of the economy and the relatively low unemployment rate, together with the high price of oil, as reason to sound the alarm concerning inflationary pressures. Thus we expect a gradual increase in interest rates in the coming years from the current low level. If this increase in interest rates changes the relationship between Canadian and US interest rates, Canadian interest rate increases would in turn put further upward pressure on the Canadian dollar, thus exacerbating the impact on the manufacturing sector discussed above.

Finally, we expect economic growth in the US to continue to be robust, though we expect US real GDP growth rates to decline slowly over time.

Comparison of Current and Past Macroeconomic Forecasts

Recent natural catastrophes and variations in oil and gas prices are the main factors leading to revisions in CCPA's consensus forecast. Table 3 compares the current macroeconomic forecast to both CCPA's July 2005 macroeconomic forecast and the forecast contained in the February 2005 budget.

Largely because of the mildly net positive impact of higher oil and gas prices, CCPA has re-

vised our forecast of GDP growth and employment growth upward. These forecasts are now equal to what had been envisioned in the February budget for 2005, though the CCPA outlook for employment growth still stands a little lower than the budget's for 2006 and 2007. Improved nominal GDP growth is an important factor in enhancing the fiscal position for the federal government, since nominal GDP is, in effect, the government's aggregate tax base.

The CCPA consensus forecast for long-term interest rates has been revised downward for the current year and slightly upward for 2006. As such, it now stands below the 2005 federal budget forecast by 50 basis points for 2005 and 2006, and by 40 basis points in 2007. This is consistent with the so-called 'Greenspan Conundrum' observed in the US, in which current long term interest rates are lower than expected given recent increases in short-term rates and the health of the economy.

Finally, in light of the impact of the hurricanes and the rise in oil prices on the US economy, the CCPA consensus forecast for the growth in US GDP has been revised downward for 2005. This modification is also motivated by the emergence of relatively low levels of US consumer confidence by historical standards.

However, this reduction is both slight — the forecasted US real GDP growth is reduced by only 0.1 % — and temporary. Given the expansionary stance of the fiscal policy of the US government, combined with the small reconstruction boom expected in the states affected by the hurricanes, the CCPA forecast calls for an increase in growth rates for 2006 by the same amount.

TABLE 3 Comparison of the Government's 2005 Budget Macroeconomic Forecast and CCPA Macroeconomic Forecasts of October 2005 and July 2005

(Per Cent)	2005	2006	2007
Real GDP Growth			
February 05 budget	2.9	3.1	2.9
July CCPA report	2.7	2.9	n/a
October CCPA report	2.9	3.1	2.9
GDP Inflation			
February 05 budget	2	1.9	1.9
July CCPA report	2.3	2.1	n/a
October CCPA report	2.3	2.1	2.0
Nominal GDP Growth			
February 05 budget	4.9	5	4.8
July CCPA report	5	5	n/a
October CCPA report	5.2	5.2	4.9
3 month Treasury Bill Rate			
February 05 budget	2.7	3.5	4.6
July CCPA report	2.6	3.5	n/a
October CCPA report	2.6	3.5	4.0
10 year Government Bond Rate			
February 05 budget	4.6	5.1	5.6
July CCPA report	4.3	4.5	n/a
October CCPA report	4.1	4.6	5.2
Unemployment Rate			
February 05 budget	7.2	7	6.7
July CCPA report	6.9	6.9	n/a
October CCPA report	6.9	6.9	6.7
Employment Growth			
February 05 budget	1.4	1.5	1.4
July CCPA report	1.3	1.2	n/a
October CCPA report	1.4	1.4	1.3
US Real GDP Growth			
February 05 budget	3.6	3.4	n/a
July CCPA report	3.6	3.2	n/a
October CCPA report	3.5	3.3	3.2

SOURCES Canadian Centre for Policy Alternatives, Finance Canada and Informetrica

3 The Federal Fiscal Forecast

Introduction to The CCPA Federal Fiscal Forecast

The CCPA federal fiscal forecast presents the outlook for federal finances on a “status-quo” basis, in the sense that we assume that the current public policy framework will prevail. Thus we anticipate that existing patterns discernable in government revenues, expenditures and debt service charges will continue. Cases in which we depart from this assumption will be signaled in the text.

This “status-quo” assumption frees us from the attempt to anticipate the outcome of current policy debates that may alter the future fiscal outlook. For example, we have not taken into account the impacts of the proposed legislation to allocate future budget surpluses. Because this legislation could continue the tax reductions triggered by one year’s budget surplus into future years, this legislation would have a significant impact on our forecast for later years.

The “status-quo” assumption also implies that no allowances are made for the possibility of large “surprise” expenses, unforeseen accounting provisions or the creation of trust funds to pay for multi-year spending commitments. This assumption is reasonable given that a forecaster located outside the Finance Department has no capacity to foresee what these unexpected developments

might be. However, given the dramatic impact of the treatment of expenses during the 2004/05 fiscal year, the inability to anticipate these expenses poses a serious obstacle for independent fiscal forecasting.

This report estimates the “underlying surplus” — that is the budget surplus prior to the subtraction of the government’s customary \$3 billion contingency reserve or the other funds typically set aside for “economic prudence”. Economic prudence is assumed to be \$1 billion in 2005/06, rising to \$2 billion in 2006/07 and \$3 billion in 2007/08.

In keeping with the other independent forecasters reporting to the Finance Committee, we assume that the annual contingency fund is used for debt repayment. We assume that only the \$3 billion contingency reserve is used to repay federal debt each year. Thus the remainder of the underlying surplus is available to fund spending or tax reduction initiatives beyond those contemplated by the 2005 budget and by post-budget changes announced to date.

As discussed in section one of this report, the Government’s explicit commitment to make changes in taxation or spending activities contingent on a certain level of surplus makes the forecasting of future budget surpluses both more important and more uncertain. At present, this issue surfaces in Bill C-48, which authorizes the

TABLE 4 The Outlook for Budgetary Revenue

Tax Revenues (\$Billions)	2003-04 (actual)	2004-05 (actual)	2005-06	2006-07	2007-08
Income Tax					
Personal Income Tax	84.9	89.8	96.4	101.9	106.8
Corporate Income Tax	27.4	30.0	31.9	32.6	33.7
Other Income Tax	3.1	3.6	3.7	3.9	4.1
Total	115.5	123.4	132.0	138.4	144.6
Other Taxes and Duties					
Goods and Services Tax	28.3	29.8	31.9	33.4	34.7
Customs & Import duties	2.9	3.1	3.3	3.4	3.6
Energy	5.0	5.1	5.3	5.6	5.9
Other	5.2	5.0	5.1	5.2	5.3
Total	41.4	42.9	45.6	47.6	49.5
Total Tax Revenues	156.8	166.2	177.6	186.0	194.1
Employment Insurance Premium Revenues	17.5	17.3	17.6	17.8	17.7
Other Revenues	11.8	14.9	12.8	12.9	13.2
Total Budgetary Revenues	186.2	198.4	208.0	216.6	224.9
Per Cent of GDP					
Income Tax					
Personal Income Tax	7.0	7.0	7.1	7.1	7.1
Corporate Income Tax	2.3	2.3	2.3	2.3	2.2
Other Income Tax	0.3	0.3	0.3	0.3	0.3
Total	9.5	9.6	9.7	9.7	9.7
Other Taxes and Duties					
Goods and Services Tax	2.3	2.3	2.3	2.3	2.3
Customs & Import duties	0.2	0.2	0.2	0.2	0.2
Energy	0.4	0.4	0.4	0.4	0.4
Other	0.4	0.4	0.4	0.4	0.4
Total	3.4	3.3	3.4	3.3	3.3
Total Tax Revenues	12.9	12.9	13.1	13.0	13.0
Employment Insurance Premium Revenues	1.4	1.3	1.3	1.2	1.2
Other Net Revenues	1.0	1.2	0.9	0.9	0.9
Total Budgetary Revenues	15.3	15.4	15.3	15.2	15.0

NOTE Numbers may not add due to rounding

government to increase expenditures by \$2.25 billion in both 2005/06 and 2006/07 so long as this additional spending leaves a federal budget surplus greater than \$2 billion.

To deal with the uncertainty implied by such contingent spending commitments, and to enhance transparency of our projections, we have elected to separate program expenditures into two categories. The category “program spending excluding contingent spending” contains all expenditures which are not explicitly contingent (i.e. all expenditures other than those in Bill C-48). The category “contingent program spending” consists of spending commitments made on a conditional basis (at present Bill C-48). Since the spending contained in Bill C-48 is explicitly confined to 2005/06 and 2006/07, we have not assumed any continuation of these spending commitments beyond 2006/07.

Highlights of The CCPA Federal Fiscal Forecast

The CCPA projects budget revenues of \$208 billion in 2005/06, which results in a revenue/GDP ratio of 15.3%. In future years, federal revenues fall slightly as a percentage of GDP. This is the reflection of several factors, most obviously the economic slowdown as real GDP growth is projected to go from 3.1% in 2006 to 2.9% in 2007. This is partly predicated on the expectation that the Bank of Canada will raise interest rates in the coming years.

While corporate income tax revenues are estimated at \$31.9 billion, or 2.3% of GDP in 2005/06, this falls gradually through the forecast period to 2.2% by 2007/08. Corporate income tax revenues in 2005/06 reflect the fact that corporate profits as a share of GDP are currently at record levels, but this growth in corporate profits is expected to decelerate. We assume that any decline in corporate profits as a percentage of GDP is mirrored

by a corresponding increase in personal income as a percentage of GDP. This, along with resulting growth of PIT revenue that results when personal income growth pushes Canadians into higher tax brackets, has informed our assessment that personal income tax revenue will be a relatively strong in 2005/06 at \$96.4 billion or 7.1%. However, the growth of personal income tax revenues is moderated by the cuts in personal income taxes announced in the 2005 Budget for future years.

Program spending is projected at \$162.7 billion in 2005/06, which results in a program spending to GDP ratio of 12% (assuming that the contingent spending of Bill C-48 occurs). Program spending diminishes as a percentage of GDP thereafter, particularly in 2007/08 when Bill C-48 spending ceases.

These projected program spending to GDP ratios are considerably below the program spending to GDP ratio of 12.6% in 2004/05. However, the 2004/05 ratio is aberrant in that it reflects the impact of the many multi-year expenses charged against the 2004/05 surplus (see section 1 of this report). For example, if all of these five expenditures are removed from program spending in 2004/05, program spending to GDP ratio would stand at 11.7%. This is just slightly higher than the 2003/04 program spending to GDP ratio of 11.6%.

We foresee that servicing the public debt will become somewhat less costly in 2005/06 than it was in 2004/05. As we argued in our July 2005 forecast, debt service costs may decrease in an environment of rising interest rates, even if we assume no debt repayment. This is the result of the fact that savings on debt service costs are produced when government debt is rolled over at current interest rates that are lower than the previous interest rates the debt carried. Thus the government should continue to realize savings from refinancing debt that carried higher interest rates in the 1990s, even if current interest rates

TABLE 5 Summary Statement of Transactions

Budgetary Transactions (\$Billions)	2003-04 (actual)	2004-05 (actual)	2005-06	2006-07	2007-08
Revenue	186.2	198.4	208.0	216.6	224.9
Program Spending (excluding Contingent Spending)	141.4	162.7	160.4	168.2	175.8
Contingent Spending (Bill C-48)			2.3	2.3	
Total Program Spending	141.4	162.7	162.7	170.4	175.8
Debt Service	35.8	34.1	33.9	33.7	33.7
Underlying Budget Surplus	9.1	1.6	11.4	12.5	15.4
Prudence					
Contingency Reserve			3.0	3.0	3.0
Economic Prudence			1.0	2.0	3.0
Total			4.0	5.0	6.0
Budgetary Balance	9.1	1.6	7.4	7.5	9.4
Federal Debt (accumulated deficit)					
Apply Contingency Reserve to Debt	501.5	499.9	496.9	493.9	490.9
Per Cent of GDP					
Revenue	15.3	15.4	15.3	15.2	15.0
Program Spending (excluding Bill C-48)	11.6	12.6	11.8	11.8	11.7
Bill C-48			0.2	0.2	
Total Program Spending	11.6	12.6	12.0	11.9	11.7
Debt Service	2.9	2.6	2.5	2.4	2.3
Underlying Budget Surplus	0.7	0.1	0.8	0.9	1.0
Federal Debt (assuming Contingency Reserves applied to Debt)	41.2	38.7	36.6	34.6	32.8

NOTE Numbers may not add due to rounding

increase moderately. In addition, the shift in composition of the federal debt towards more short term debt produces debt service savings. Both our perspective on debt services costs, as well as GDP growth, produce a debt service to GDP ratio that falls gradually over the forecast period.

The CCPA projects an underlying budget surplus of \$11.4 billion in 2005/06, going to \$12.5 billion in 2006/07 and \$15.4 billion in 2007/08. Note that this surplus projection includes the full spending increase negotiated between the NDP and the Government in Bill C-48.

The CCPA Forecast Versus The Government's 2005 Budget Forecast

CCPA's forecast of the underlying budget surplus far exceeds the official estimates presented in the Finance Minister's 2005 budget. The revenue projections contained in the 2005 budget are implausibly low. In fact, the revenue projections offered in that document show the revenue to GDP ratio for 2005/06 as having fallen precipitously to 14.8 % of GDP, with this ratio declining still fur-

TABLE 6 Comparison of the Government's Budget 2005 and Current CCPA Projections

Budgetary Transactions (\$Billions)	2005-2006	2006-2007	2007-2008
Total Budgetary Revenues			
<i>Current CCPA</i>	208.0	216.6	224.9
Budget	200.4	210.1	220.4
Total Program Spending (including Bill C-48)			
<i>Current CCPA</i>	162.7	170.4	175.8
Budget	161.3	169.5	177.9
Debt Service			
<i>Current CCPA</i>	33.9	33.7	33.7
Budget	35.1	35.6	36.4
Underlying Budget Surplus			
<i>Current CCPA</i>	11.4	12.5	15.4
Budget	4.0	5.0	6.0
Federal Debt (assuming Contingency Reserves applied to Debt)			
<i>Current CCPA</i>	496.9	493.9	490.9
Budget	495.5	492.5	489.5
Per Cent of GDP			
Total Budgetary Revenues			
<i>Current CCPA</i>	15.3	15.2	15.0
Budget	14.8	14.7	14.7
Total Program Spending (including Bill C-48)			
<i>Current CCPA</i>	12.0	11.9	11.7
Budget	11.9	11.9	11.9
Debt Service			
<i>Current CCPA</i>	2.5	2.4	2.3
Budget	2.6	2.5	2.4
Federal Debt (assuming Contingency Reserves applied to Debt)			
<i>Current CCPA</i>	36.6	34.6	32.8
Budget	37.0	35.2	33.5

ther thereafter. This underestimation of revenue is due in large part to the Finance Department's low estimates for personal and corporate income tax revenues. It should be acknowledged that the Department's 2005 Budget predated the recent increases in oil prices, and at that time the Finance Department was employing a lower forecasted nominal GDP growth. However, the high corporate profitability that prevailed at the time that the budget was written is dramatically at odds with the low projected corporate income tax revenues contained in the Budget. Furthermore, CCPA's forecast of the unemployment rate is lower than the Budget's for 2005 and 2006, which suggests an underestimation of personal income tax revenues for these years.

In addition to these low revenue estimates, Budget 2005 provides high program expenditure estimates. The Budget claims that program expense for future years will be at 11.9% of GDP. This seems unjustifiably high, particularly since the spending included in Bill C-48 was not in existence at the time of the February budget. Program spending to GDP has not exceeded 11.6% of GDP since 1998/99 (with the exception of the anomalous result for 2004/05 discussed above)

Debt service payments are also on the high side. Debt service costs were projected at \$34.7 billion in 2004/05, which turned out to be about \$600 million higher than the actual \$34.1 billion disclosed after final year-end adjustments. There is no obvious explanation for this overestimate, given that the budget is released quite close to the fiscal year end, at which time quite reliable estimates of debt service costs should be available to the Finance Department.

From this exaggerated 2004/05 base, the government projects that debt service costs will increase at an accelerating rate until 2007/08. As we argued in our July forecasting report, this seems implausible given the debt management strategy of the government and the relatively limited im-

pect of upward pressure on interest rates on the government's overall debt service costs. In any case, CCPA's forecast of long-run interest rates is lower than what assumed in the February 2005 budget by a full 0.5% for both 2005 and 2006. The government's debt service costs estimates seem even more suspect given that these estimates are prepared under the assumption that the federal debt is declining by \$3 billion per year as the contingency reserves are applied to debt repayment. All of these factors point to lower debt service costs than those forecast by the government.

A Comparison Of CCPA's October 2005 And July 2005 Forecast

The actual 2004/05 surplus disclosed in October 2005 was \$1.6 billion. Our July fiscal forecast estimated that the 2004/05 budget surplus would be \$6.8 billion. However, at the time of the July forecast, we were not privy to the decisions taken regarding Atomic Energy of Canada's environmental liabilities, nor the decision to expense the multi-year costs of the Offshore Agreements against the 2004/05 budget year. As Table 1 indicates, had the Government not expensed these items in this manner, the federal budget surplus for 2004/05 would have been \$6.5 billion.

While the overall budget surplus number projected by CCPA is quite close to the actual surplus (adjusted for surprise expenditures), the various categories which produced the CCPA estimate differed from the actual amounts as follows. The CCPA July forecast underestimated revenues (we projected \$197.4 billion and the actual number was \$198.4). The CCPA July forecast also underestimated program spending (we projected \$156.5 billion compared with an actual program spending estimate which would have equaled \$157.8 billion excluding these two surprise items).

In addition to adjusting the 2004/05 base year to reflect actual totals disclosed in the October

TABLE 7 A Comparison of CCPA's July 2005 and October 2005 Forecasts

Budgetary Transactions (\$Billions)	2004-2005	2005-2006	2006-2007
Revenue			
<i>July</i>	197.4	205.5	215.5
Current	198.4	208.0	216.6
Total Program Spending (including Bill C-48)			
<i>July</i>	156.5	162.1	170.5
Current	162.7	162.7	170.4
Debt Service			
<i>July</i>	34.1	33.9	33.7
Current	34.1	33.9	33.7
Underlying Budget Surplus			
<i>July</i>	6.8	9.5	11.3
Current	1.6	11.4	12.5
Federal Debt (assuming Contingency Reserve applies to Debt)			
<i>July</i>	498.1	495.1	492.1
Current	499.9	496.9	493.9
Percent of GDP			
Budgetary Revenues			
<i>July</i>	15.3	15.2	15.2
Current	15.4	15.3	15.2
Total Program Expenses			
<i>July</i>	12.1	12.0	12.0
Current	12.6	12.0	11.9
Public Debt Charges			
<i>July</i>	2.6	2.5	2.4
Current	2.6	2.5	2.4
Federal Debt (assuming Contingency Reserve applies to Debt)			
<i>July</i>	38.6	36.5	34.6
Current	38.7	36.6	34.6

Annual Financial Report, CCPA's forecast of future economic conditions is now more optimistic than it was in July. The higher base-year figures and higher estimates for GDP growth and the rate of employment creation have led us to reexamine our revenue estimates. Our present fiscal forecast suggests higher projected revenues than did CCPA's July fiscal forecast, particularly for 2005/06. This is due in part to the higher-than-forecast actual revenue for 2004/05, which serves as the base for future projections, and in part to stronger GDP growth. It also reflects our somewhat more optimistic outlook on both personal income tax revenues and corporate income tax revenues.

CCPA's October program spending estimates and debt service charge estimates are broadly congruent with our July estimates (given of course

the change in macroeconomic circumstances that has occurred in the intervening time). It should be noted that we have adjusted program spending in 2005/06 and beyond to reflect that fact that Offshore Agreement spending which had been recorded in those years has now been accounted for as an expenditure in 2004/05. At the same time, our forecast recognizes spending (such as the government's response to higher energy costs) announced after the July forecast date.

Our current forecast of the 2005/06 budget surplus is about \$1.9 billion higher than was our July forecast. The 2006/07 budget surplus forecast has been revised upward by 1.2. This is due to several factors, such as stronger GDP growth forecasts, and changes in our outlook for personal and corporate income taxes.

Conclusion

Several conclusions can be drawn from CCPA's forecast of the federal fiscal position for 2005/06 through 2007/08.

First, it is clear that the final surplus of \$1.6 billion in 2004/05 was unusually low. Thus this seemingly low budget surplus does not reflect any deterioration in the government's underlying financial position. It reflects the timing of expenditures.

Secondly, despite the fact that the government's forecasted budget surplus for 2004/05 is closer to its actual budget surplus than has been the case in many years, this does not constitute an improvement in the government's record of forecasting inaccuracy and poor financial transparency. The creation of a low budget surplus figure for 2004/05 via the repayment of expenditures merely replaces one form of questionable financial transparency with another. Indeed, it is remarkably convenient that the government has elected to book these "surprise" expenditures to deplete the 2004/05 surplus at the moment in which considerable media attention has been fo-

cused on their record of posting large "surprise" surpluses.

Thirdly, the 2004/05 budget surplus in no way heralds the beginning of a new era of low federal budget surpluses. CCPA's estimates for upcoming budget years indicates that, in the absence of any unforeseen manipulation of the timing of revenues or expenditures, underlying budget surpluses in the future will continue to be large. This indicates that the government has the financial resources to enable it to use its sizeable forthcoming surpluses to meet the needs of Canadians, without risk of incurring a budgetary deficit.

Finally, Canadians now have further reason to demand increased transparency in official federal forecasting and in other government disclosures related to its financial position. With the possibility that more budgetary decisions may be made contingent on the size of the federal budget surplus, it is imperative that the Finance Department be prevented from manipulating federal finance to further political objectives.

Notes

- 1** We arrive at this figure by adding to the existing surplus of \$1.6 billion the full \$2.3 billion charge related to Atomic Energy of Canada and \$2.6 billion for offshore agreements (the full cost of those agreement less the amount that was expensed in Budget 2005).
- 2** The motivation for this choice is laid out in greater detail in the July 2005 report.