Alternative Federal Budget 2003

Economic and Fiscal Update

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The Alternative Federal Budget is prepared each year by a coalition of community, labour, and social advocacy organizations, coordinated by the Canadian Centre for Policy Alternatives. The 2003 Alternative Federal Budget will be released by the project in February 2003, about the same time as the next federal budget. This statement represents the current thinking of AFB participants regarding the current fiscal situation faced by the federal government, and outlines the broad policy options which will shape the coming budget-making process. For further information on the Alternative Federal Budget, please visit www.policyalternatives.ca.

Summary

- The federal government's fiscal situation is much more positive than has been suggested by federal officials and private sector forecasters. The government recorded an $8.9 billion surplus in fiscal 2001-02, and the federal balance will get even stronger over the coming years on the strength of renewed economic growth in Canada.

- On the basis of plausible assumptions regarding macroeconomic conditions, we project that the federal government will generate a surplus in the current fiscal year in excess of $10 billion. In the absence of discretionary tax and spending measures, that surplus will swell to over $17 billion by fiscal 2003-04.

- Finance officials, backed by most private-sector forecasters, are predictably downplaying the possibility of such large surpluses. The credibility of their projections is doubtful, however, given past efforts to deliberately understate the true budget balance.

- Over the past three fiscal years the federal government has generated a cumulative surplus of almost $40 billion–a surplus which was predicted accurately in the annual projections of the Alternative Federal Budget, but hidden in official budget documents through misleading economic assumptions and other questionable budgeting techniques.

- Despite this optimistic medium-term budget forecast, the longer-run budgetary leeway of the federal government may be constrained by the decline in federal fiscal capacity which is now apparent. Federal revenues fell steeply as a share of GDP last year, thanks largely to personal and corporate income tax cuts, to the lowest level during the Chrétien era. Given the growing demands on the federal government for timely–and expensive– investments in programs like medicare, infrastructure reconstruction, and environmental protection, this decline in federal taxation will need to be arrested and reversed.

Threats to the Budget Have (Once Again) Been Greatly Exaggerated

Despite a sharp but temporary slowdown in economic growth in Canada during 2001, the federal government managed to report a large budget surplus for fiscal 2001-02, equal to $8.9 billion. The healthy rebound in macroeconomic conditions in Canada during 2002 will ensure that the underlying federal fiscal situation improves even further. Indeed, economic circumstances seem tailor-made for a strong advance in the federal government's fiscal position. Job-creation has been very strong (some 450,000 additional Canadians were working, and paying taxes, in September 2002 compared to September 2001), and real GDP will expand this year at a rate close to 4 percent. At the same time, the general price level has begun to increase once again following a temporary period of deflation in 2001, further boosting the federal government's nominal revenue flows. Interest rates, however, will remain at historically low levels for some time to come despite this modest acceleration in inflation, because the Bank of Canada remains concerned about the impact of international and financial market uncertainty on domestic growth and the risk of war in the Middle East.

These circumstances suggest that, barring significant discretionary changes in spending and taxation policies, the federal surplus is poised to swell again in the coming two years to rival the record surplus which was generated in fiscal 2000 ($18.1 billion). Revenues are booming thanks to strong job creation, real economic growth, and a rebound in nominal price levels. Strengthening labour markets imply lower-than-expected payouts for employment insurance. Debt service costs will decline in light of historically low interest rates, and continued absolute and relative shrinkage in the federal debt burden.

Table 1 provides a summary fiscal forecast for the federal government which takes account of these uniformly positive underlying economic drivers. The table forecasts key fiscal parameters for fiscal years 2002-03 and 2003-04, on the basis of the following simple (and generally conservative) assumptions:

- Annual average real GDP growth is assumed to equal 3.5 percent in calendar year 2002, and 3.25 percent in calendar year 2003. This is consistent with the projections contained in the Bank of Canada's recent *Monetary Policy Report* (October 2002, p. 22); for 2003 we have used the midpoint of the Bank's forecast range. These assumed growth rates are slightly *lower* than the currently reported consensus of private forecasters. Calendar year growth rates of 3.5 and 3.25 percent for 2002 and 2003, respectively, translate into annual average fiscal year growth rates of 3.8 and 3.1 percent for 2002-03 and 2003-04, respectively.[1]

- Average price levels in the economy (as measured by the GDP deflator) are assumed to recover from the deflation experienced in 2001, and begin to grow at annual average rates of 2.5 percent and 2 percent in 2002 and 2003, respectively. This is broadly in line with the Bank of Canada's current expectation that year-over-year CPI inflation will peak later this year at close to 3 percent, falling back toward the 2 percent level during 2003. During the first half of calendar 2002, GDP prices grew at an annual rate in excess of 5 percent, so this assumption is likely conservative.

- The effective average interest rate on federal debt is assumed to stay constant at the fiscal 2001-02 level (7.0 percent of net federal debt). Even though short-term interest rates will begin to increase again during the next two years, this will be roughly offset by the continued benefits for the federal government of refinancing expired bonds initially issued in earlier years when interest rates were much higher than at present. Long-term interest rates on newly-financed federal debt remain at historically low levels.

- Total federal revenues are assumed to equal the same proportion of nominal GDP as was experienced during fiscal 2001-02 (15.8 percent).[2] The tax cuts promised by the federal government in the 2000 federal election are now mostly in place, so aggregate effective tax rates will not change much for statutory reasons. One exception is corporate tax rates, which were reduced by 2 points in fiscal 2002-03 and will fall another 2 points in 2003-04. This decline in the statutory corporate tax rate, however, will be offset by other factors–in particular by the recovery in pretax corporate profits, and by the payment of extra small business taxes which were granted a one-time deferral in the last budget. Coming declines in EI premium rates will be offset by growing employment levels. On the whole, therefore, barring additional tax changes, there is no compelling reason to expect that aggregate federal revenues will fall further as a share of Canada's GDP over the next two years, and they may actually grow (since the revenue-to-GDP ratio tends to vary pro-cyclically with macroeconomic conditions).

- Federal program spending in the current fiscal year, and in fiscal 2003-03, is assumed to match the levels projected in the December 2001 *Budget Plan*. This assumption may also be somewhat conservative. Final program spending for fiscal 2001-02 was almost $4 billion underbudget (thanks in part to lower-than-budgeted EI benefits, and in part to the failure of provincial governments to fully utilize authorized shared-cost program opportunities). For both reasons, program spending (again, in the absence of additional discretionary policy changes) may continue to fall below budgeted levels during the current and coming fiscal years.

On the basis of these straightforward assumptions, Table 1 projects key fiscal indicators for the federal government for fiscal years 2002-03 and 2003-04. Barring additional discretionary changes in tax and spending programs, we expect the federal government to post a surplus exceeding $10 billion in the current year, and exceeding $17 billion in 2003-04.[3] Budgeted program spending stays constant as a share of GDP, at about 11.5 percent, while debt service charges continue to decline in both absolute and relative importance. With continued economic growth (both real growth, and growth in nominal price levels) driving up federal revenues point for point, the obvious result is a large and growing federal surplus. On these assumptions, the federal government will generate a huge surplus next year–barring discretionary tax or spending changes–that will rival the all-time record surplus declared in fiscal 2000.

Table 1
Status-Quo Federal Fiscal Outlook
(fiscal years)

	1999-00	2000-01	2001-02	2002-03	2003-04
Budgetary Indicators ($billion)					
Revenue	166.1	179.6	173.3	184.2	193.9
Program Spending	111.8	119.3	126.7	136.6	140.2
Debt Service	41.6	42.1	37.7	37.2	36.2
Budget Balance	12.7	18.2	8.9	10.4	17.5
Closing Debt	563.5	545.3	536.4	526.0	508.5
Macroeconomic Indicators (%)					
Effective Interest Rate, Federal Debt[1]	7.3	7.6	7.0	7.0	7.0
Real GDP Growth	5.5	3.9	1.4	3.8	3.1
GDP Inflation[2]	2.7	3.8	-0.2	2.4	2.1
Revenue/GDP	16.6	16.6	15.8	15.8	15.8
Pgm. Spending/GDP	11.2	11.0	11.6	11.7	11.5
Closing Debt/GDP	56.2	50.4	49.0	45.2	41.5

See text for assumptions and methodology. Table summarizes the federal budget balance that would occur in the absence of additional discretionary tax and spending policy measures.
1. *Debt service as share of average debt*
2. *Change in 1997 chain-price GDP deflator.*

Soaring Surpluses, Sinking Credibility

The preceding conclusion seems surprising in light of the generally pessimistic fiscal projections which have been outlined in recent months by Finance Minister John Manley, and by most private-sector economists. The standard wisdom suggests that the federal fiscal balance is becoming uncomfortably tight. The political message implicit in these projections is that Canadians should dampen their hopes for significant new federal fiscal initiatives–including the numerous program initiatives which were outlined in September's throne speech.

The underlying arithmetic of federal finances, however, indicates that this pessimism is misplaced at best–if, indeed, it is not deliberately intended to mislead. The federal government survived a significant but temporary economic slowdown in 2001 while maintaining a fiscal surplus equal to almost a full percentage point of GDP. Now Canada's economy and labour market are improving strongly, outperforming most of the rest of the industrial world. The modest spending commitments which the federal government made in its 2001 budget do not come close to consuming the fiscal space which this growth creates with each passing month. The unavoidable conclusion is that an already-strong federal fiscal balance is getting significantly stronger.

The credibility of federal claims that the budget is tightly balanced must be questioned, in light of experience with past Liberal budget projections. The federal government has exceeded the official balance projected in its budgets in every single fiscal year since it took office in 1993. The cumulative value of this increasingly phony overperformance now exceeds $80 billion. In recent years, finance ministers and private-sector advisors alike have stuck religiously to the official fiction that the federal budget has no room for important spending initiatives. But these claims tend to reflect the shared bias of these analysts in favour of continued spending restraint and debt reduction, and their opposition to significant new investments in public programs.

Table 2 summarizes the differences between projected and actual budget surpluses over the past three fiscal years. During this time, the federal government budgeted only for small fiscal surpluses,[4] and repeatedly warned Canadians not to count on any expensive new federal program initiatives–no matter how urgent their concerns over health care, the physical and social infrastructure, and the environment. But in reality, the federal government generated almost $40 billion worth of surpluses in those three years. Much of this money should have been reinvested to repair the human damage that has been done by close to a decade of unprecedented fiscal restraint.

Interestingly, the documents of the Alternative Federal Budget predicted the size of the actual surpluses with much greater accuracy than the (official) budget plans of the federal government. For fiscal 2001-02, the AFB's projection (contained in its December 2001

Table 2
Forecast and Actual Federal Budget Balances 1999-00 through 2001-02
($billion)

	Official Budget Target[1]	AFB Estimate[2]	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
Total	**7.5**	**40.0**	**39.7**

1. Equal to balance of "budget for planning purposes," excluding contingency reserve fund, from each annual federal budget.
2. Estimates of status-quo federal surplus reported in Vital Measures, Alternative Federal Budget 1999 (February 1999); Reality Check: An Alternative Economic Update (October 2000); and Alternative Federal Budget Economic and Fiscal Statement (December 2001), respectively.

Economic and Fiscal Statement) of an $8.5 billion surplus was almost exactly correct. And over the three-year period, the annual AFB projections forecast a cumulative $40 billion surplus –just a shade over the actual $39.7 billion that was recorded. It is clear that both federal finance officials and the bank economists and other private-sector forecasters who are their primary advisors, have allowed their collective bias in favour of continuing fiscal restraint to cloud the accuracy of their own (official) fiscal forecasts.

A Self-Inflicted Fiscal Squeeze?

The federal government is poised to generate large budgetary surpluses in the next couple of years. At the same time, however, the government faces an imposing list of concerns and issues which Canadians are demanding be addressed–ranging from the fiscal repair of our medicare system, to the physical repair of the national public water infrastructure, to the social repair of cities and neighbourhoods which have been hard-hit by fiscal downloading and cutbacks. Most of these demands reflect the cumulation of unmet human and social needs during the last several years of unprecedented fiscal restraint. The Chrétien-Martin fiscal legacy is an enormous backlog in unmet needs for public services and social and environmental security. Federal program spending during the current Liberal regime has fallen by almost one-third, measured as a share of GDP–from 16.5 percent in fiscal 1993-94, to just 11.6 percent last year.

And while federal government finances continue to demonstrate an impressive strength, Canadians are suddenly convinced that a great deal needs to be done in public programs to make up for the one-sided fiscal approach that has been taken during the Chrétien administration. The ambitious if vague content of the throne speech reflects this fundamental shift in the attitude of Canadians. They are asking governments to act positively to enhance their quality and security of life, and governments are beginning to listen.

The optimistic fiscal projections outlined above indicate clearly that the federal government can *begin* to make important progress in addressing Canada's social deficit, even without changes in tax policy. However, it may well be the case that the government does not have sufficient resources, given current tax policies, to fund the urgent investments which Canadians are demanding in a wide range of priority areas. These actions, if they are to be effective, will require the commitment of substantial resources.

Some of the major spending priorities which the federal government will need to respond to in its next budget will include:

- A politically irresistible demand to fundamentally repair the fiscal foundation of public health care in Canada, which will reach its peak with the coming report of the Romanow commission. This will require several billions of dollars in additional funding from the federal level.[5]

- The glaring need to back up the federal commitment to ratify the Kyoto Protocol on global climate change with real actions and real resources, also likely costing in the billions.

- The gamut of other programs and initiatives which were identified in the throne speech, including child care, infrastructure, poverty, and low-cost housing.

All told, these various new programs will put considerable strain on the federal treasury, despite the otherwise healthy fiscal trends which were summarized above. By neglecting its broad social responsibilities for most of the last decade, the federal government has allowed a backlog of social and human needs to build up in our society. It will now require determined political leadership, and vast resources, to address that backlog–in short, a war on the social deficit that must be every bit as historic and determined as was the war on the fiscal deficit.

To the extent that the federal fiscal balance does indeed become challenged during this effort–and it is clear, as reported above, that the federal government will have to spend a very large amount of money indeed before it puts its budgetary balance at risk–then that fiscal squeeze is entirely self-inflicted. Thanks to the tax cuts which it promised during the 2000 election, the federal government is undermining its fiscal capacity to fund the programs and initiatives which Canadians are demanding. Indeed, largely as a result of personal and corporate income tax cuts, federal revenues declined substantially last fiscal year as a share of Canada's GDP. For the first time during the current government's tenure, federal revenues dropped below 16 percent of GDP. This is well below the long-term average for Canada's federal government (see Table 3). (Program spending, of course, fell far below its long-run average in the wake of the spending cuts of the late 1990s.) If macroeconomic conditions deteriorate by mid-decade, then federal revenues will fall further as a share of GDP, perhaps below 15 percent–a level that has not been experienced since 1963.

At present, then, the federal government collects significantly less revenues (relative to Canada's economy) than federal governments did in the past. In the longer-run, this revenue-generating capacity may decline further in the face of macroeconomic weakness and/or additional tax cuts. Yet the government faces an unprecedented call from Canadians for major reinvestments in a wide range of important, and expensive, program areas. If the current government genuinely wants to leave a legacy of federally-supported programs that improve the quality of living for Canadians, then it will eventually need to arrest and reverse this erosion in its own revenue base.

Table 3
Federal Finances, Now and Then
(% of GDP)

	Revenues	Program Spending
40-year Federal Average (1961-2001)	16.4	15.9
Chrétien Government Average (1994-2001)	16.6	12.6
2001 Actual	15.9[1]	11.6

From data reported in Department of Finance Canada, Fiscal Reference Tables (October 2002).
1. This differs slightly from the revenue share reported in Table 1 above (15.8 percent) because the Department of Finance data reported in this table uses calendar-year GDP as the denominator, rather than fiscal-year GDP.

Endnotes

1 The difference between the calendar year and fiscal year growth rates is due to the particular timing of the economic slowdown in 2001, which had its fullest effect in the 2nd and 3rd quarters of that year–hence reducing the 2001-02 base against which economic growth for the 2002-03 fiscal year is measured.

2 The GDP shares which are reported in this statement differ slightly from those reported in the recent federal *Annual Financial Report* and other Department of Finance publications. Our figures compare fiscal year budget items to the fiscal year average level of GDP (as reported by Statistics Canada's CANSIM II system); the Department of Finance publications divide by calendar year GDP.

3 Our approach here is similar to the federal government's "surplus for planning purposes": we are estimating the amount of underlying surplus that would be available for allocation to discretionary new tax or spending initiatives. In our case, however, the apparent surplus is projected without the interference of "contingency reserves" and other forms of budgetary prevarication.

4 In theory, the official target surplus was equal in each year to the "contingency reserve" which was set aside to prevent a deficit in cases in which the economy did not perform as expected.

5 The recent report of the Senate Committee on Health Care indicated additional federal spending of $6.5 billion per year for a package of new programs that may prove to be less comprehensive than Canadians want.

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