

Alternative Federal Budget 2005

Fiscal and Economic Update

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The Alternative Federal Budget is prepared each year by a coalition of community, labour, environmental and social advocacy organizations, coordinated by the Canadian Centre for Policy Alternatives. The 2005 Alternative Federal Budget will be released by the project in February 2005, 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.

Seven Years Of “Surprise” Budget Surpluses

For years the CCPA’s Alternative Federal Budget (AFB) and other critics have put the federal government in an embarrassing position. While the Finance Ministers repeatedly low-balled their surplus estimates (with the tacit blessing of the private sector forecasters they consult), the AFB’s estimates continued to accurately predict sizeable surpluses every year (see Table 1).

Over the past seven years the government’s budget forecasting developed into a predictable routine of political theatrics. Every year Canadians heard from their Finance Minister—be it Martin, Manley or Goodale—that budget surpluses were likely to be razor-thin. Then we were subjected to justification of this dire prognosis from other politicians, economists and members of the media. But when the books were closed each fiscal year – sur-

prise, surprise—the federal government repeatedly had a large surplus after all.

The AFB has consistently argued that the government was underestimating its surplus estimates by design. By concealing its mounting surpluses during the fiscal year, the government avoided pressure to use these funds to reinvest in the programs that had been slashed during the deficit-fighting years. Since the government uses funds left over after the fiscal year-ends to pay down debt, this yearly routine of “surprise” surpluses enabled the government to prioritize paying down the federal debt without having to engage in public debate as to whether Canadians really valued \$61 billion in debt repayment above other possible uses for this money.

Our AFB has long called for independent assessments of budget projections conducted by the Auditor-General to make government forecasting more transparent. Others, such as Michael Mendelson of the Caledon Institute, have called

Table 1
Forecast and Actual Federal Budget Balances 1999/2000 through 2003/04¹
(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
2003-04	1.9	8.3	9.1
Total	12.4	55.0	55.8

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); *The Cure for the Common Budget* (February 2003); and *Rebuilding the Foundations* (March 2004) respectively.

for an independent body to be set up to provide Canadians with more reliable budgetary information¹. These calls for an independent monitor of budget forecasting are also being made by the Conservative Party and the New Democratic Party.

Interestingly, mainstream budget-watchers have begun to echo the AFB's financial projections. This shift to the AFB perspective on budget surpluses arguably gained momentum during the federal election campaign, when all three national political parties cited our numbers on their election websites. Around the time of the release of the government's Annual Financial Report (October 13, 2004), the shifting consensus towards AFB surplus forecasts grew, most clearly when the TD Bank's economists published a forecast for federal finances that looked remarkably like our own.

Even the Finance Minister has been obliged to concede that past government forecasting has been problematic. Tim O'Neill, the chief economist at the Bank of Montreal, has been appointed to review Finance Canada's forecasting practices.

We will see in the government's upcoming *Economic and Fiscal Update* how far Goodale is prepared to go in providing a reasonable estimate of the federal fiscal position. Perhaps to save face (and ostensibly to provide O'Neill some time to do his job) a full transition from "Martin-math" to reasonable forecasting will not happen right away.

Our sense is that the days of the most egregious government lowballing are coming to a close. Instead the likelihood of forthcoming budget surpluses is being acknowledged alongside calls for a public debate on the use of these surpluses.

The AFB's Projections for the Status-Quo Federal Finances

Looking forward, the AFB presents the CCPA's projections of the federal government's future surplus positions.

We present "status-quo" projections on the assumption that the government will continue to

leave a large part of the demands for renewed spending priorities unmet. It assumes that past revenue patterns continue, and new spending initiatives reflect only recently announced commitments to health, equalization and a few other areas. Under these status-quo assumptions, a sizeable surplus results.

Our status-quo budget is dependent on three critical sets of assumptions: 1) the forecast of macroeconomic variables; 2) the future behaviour of tax revenues; and 3) the future behaviour of program spending. Table 2 presents our projections of the federal government's status-quo fiscal position.

Macroeconomic Variables

We intentionally adopt macroeconomic assumptions that reflect the consensus of private forecasters concerning the future direction of the economy. Our estimates for macroeconomic variables are derived in the following manner.

- 1) Real GDP growth forecast for 2004, 2005 and 2006 are taken from the most recent *Monetary Policy Report* issued by the Bank of Canada.
- 2) GDP inflation forecasts are those of the Toronto Dominion Bank for 2004-2006.² The TD forecast is similar to the forecasts of the other banks, but it has the added virtue of extending to 2006, unlike many bank forecasts that stop at 2005.
- 3) In order to avoid the difficulties of making assumptions about the future behaviour of interest rates and the impact of changes in interest rate on public debt charges, we accept the federal government's estimates of future cost of servicing the federal debt as presented in its Federal Budget 2004³. The estimates provided by Budget '04 concern the fiscal years 2003/04 to 2005/06; thereafter we assume that debt-servicing costs continue in 2006/07 at the previous year's level.

Table 2
Status Quo Budget
(billions of dollars)

Budget (in fiscal years)	2001-02 actuals	2002-03 actuals	2003-04 estimate	2004-05 forecast	2005-06 forecast	2006-07 forecast
Revenue	171.7	177.6	186.2	196.7	203.4	213.6
Status program spending	133.3	133.3	141.4	149.1	155.2	163.0
New health funding from FMM (1)				2.1	3.1	3.4
Equalization/territorial formula finance				1.5	1.6	2.0
Payments to farmers				0.5		
Technology Partnerships Canada fund (2)				0.2	0.2	0.2
Total program spending				153.4	160.1	168.7
Debt service	39.7	37.3	35.8	35.6	35.9	35.9
BUDGET BALANCE	7.0	7.0	9.1	7.7	7.4	9.0
Accumulated deficit (3)	517.5	510.6	501.5	501.5	501.5	501.5
Fiscal Indicators (in calendar years)	2001	2002	2003	2004	2005	2006
Nominal GDP growth rate	3.0%	4.3%	5.2%	5.8%	4.1%	5.0%
Real GDP growth	1.9%	3.3%	2.0%	2.9%	2.9%	3.2%
GDP inflation	1.0%	1.0%	3.2%	2.9%	1.2%	1.8%
Ratios						
Revenue/GDP	15.5%	15.4%	15.3%	15.3%	15.2%	15.2%
Status quo program spending/GDP	11.3%	11.5%	11.6%	11.6%	11.6%	11.6%
Final program spending/GDP				11.9%	12.0%	12.0%
Debt service/GDP	3.6%	3.2%	2.9%	2.8%	2.7%	2.6%
Debt/GDP ratio	46.7%	44.1%	41.1%	39.0%	37.5%	35.7%

¹ The amount for both health and equalization/TTF funding are increases compared to February 2004 as depicted at www.fin.gc.ca/fedprov/typhc_e.html

² In expectation that the government will announced approximately \$1 billion over 5 years to the Technology Partnerships Canada Fund, we register this expense as 200 million per year.

³ This assumes that the surpluses from 2004/05 forward are not used to pay down federal debt.

* Numbers may not add due to rounding.

However, because of concerns about the possibility of increasing interest rates, our estimates add \$200 million to Finance Canada's estimate of each year's debt charges as a precaution against upward pressure on debt service costs.

Tax Revenue

While the macroeconomic variables are relatively uncontroversial, the creation of estimates for government tax revenues is more problematic. Given the unreliability of the government's own forecasts

of its revenue position, we are compelled to regard its revenue projections with suspicion.

The recently released Annual Financial Report for 2003/04 illustrates that the \$9.1 billion surplus for this fiscal year was generated largely on the revenue side. Revenues came in at \$5.1 billion more than were projected in the 2004 Federal Budget. These additional revenues lifted tax revenues as a percentage of GDP from the 14.9% projected in the 2004 Federal Budget to 15.3%.

The dilemma in making future projections about tax revenue rests on the extent to which this revenue performance is likely to continue.

For the current fiscal year, we expect strong corporate profitability will continue to contribute vigorously to tax revenues. Thus we will assume that tax revenue will continue to constitute 15.3% of GDP for 2004/05. In subsequent years, we allow for a decline in CIT revenues, and adjust downward the revenue/GDP ratio to 15.2%.

Program Spending

The other large contributor to the \$9.1 billion surplus was found on the program spending side of the Federal Budget. While the Budget '04 projected that the fiscal year's program spending would be \$143.4 billion, it came in \$2.3 billion lower at \$141.4 billion. This constituted 11.6% of GDP, a slight uptick from the program spending of 2002/03 which came in at 11.5% of GDP.

To estimate program spending in the coming years, we split it into two components (see Table 2). We itemize new spending announcements — recent commitments to health care, equalization and territorial formula finance, assistance to farmers, and anticipated assistance to automotive and other sectors via the Technology Partnerships Canada Fund—separately, since we have a precise dollar figure for most of these items.

The remainder of program spending we label “Program Spending (exclusive of new spending announcements).” We assume that this spending category continues to constitute 11.6% of GDP.

When these two categories are added to derive total program spending, we project that the Liberal government will engage in program spending that constitutes 11.9% of GDP in the current fiscal year, rising to 12% of GDP in subsequent fiscal years. This amount of spending relative to GDP is still less than the 12.1% spending/GDP level achieved in 1997/98, when the budget deficit was first eliminated.

The AFB Status-quo Surplus Forecast

Looking forward, the AFB expects that the government will continue to post sizeable surpluses under status-quo assumptions, despite the recent well-publicized spending commitments. Based on the preceding assumptions, we estimate that the surpluses for the coming three fiscal years will be \$7.7, \$7.4 and \$9.0 billion, respectively. Cumulatively, this totals \$24.1 billion in status-quo surpluses over the coming three fiscal years.

Is This Surplus Sufficient To Fund Acknowledged Spending Priorities?

Is a \$24.1 billion surplus over three years sufficient to fund the necessary enhancements to program spending as well as a tax cut or debt repayment? To assess this, we first ascertain whether enhanced spending commitments that are widely supported by Canadians can be met *before* any tax cut or debt repayments can be entertained.

How to cost out the spending shortfall is debatable, but we offer this as a starting point.

Addressing the infrastructure deficit comes with a significant price tag. The Canadian Federation of Municipalities estimates the municipal infrastructure deficit alone to be in the order of \$21.5 billion. In addition, there are acknowledged infrastructure deficits in other jurisdictions.

Other priorities widely acknowledged to be urgently in need of funding are also costly. We culled from last year's AFB a list of five issues which are generally acknowledged as important priorities for the federal government: early learning and childcare, housing, post-secondary education, the meeting of Kyoto agreement obligations, and Aboriginal issues. We estimate that meeting the AFB's standards to fund these priorities alone—as this list could easily be augmented with other pressing needs—will cost in the neighbourhood of \$15 billion over three years.

We conclude that addressing these prominent spending priorities could easily consume the government's forthcoming surpluses.

Putting Spending in Perspective

Is it reasonable to demand that these forthcoming surpluses be used on program spending? The Canadian public may be under the impression that federal spending has already grown explosively. Perhaps the most frequently cited statistic is that program spending has grown 30% over the last five years.

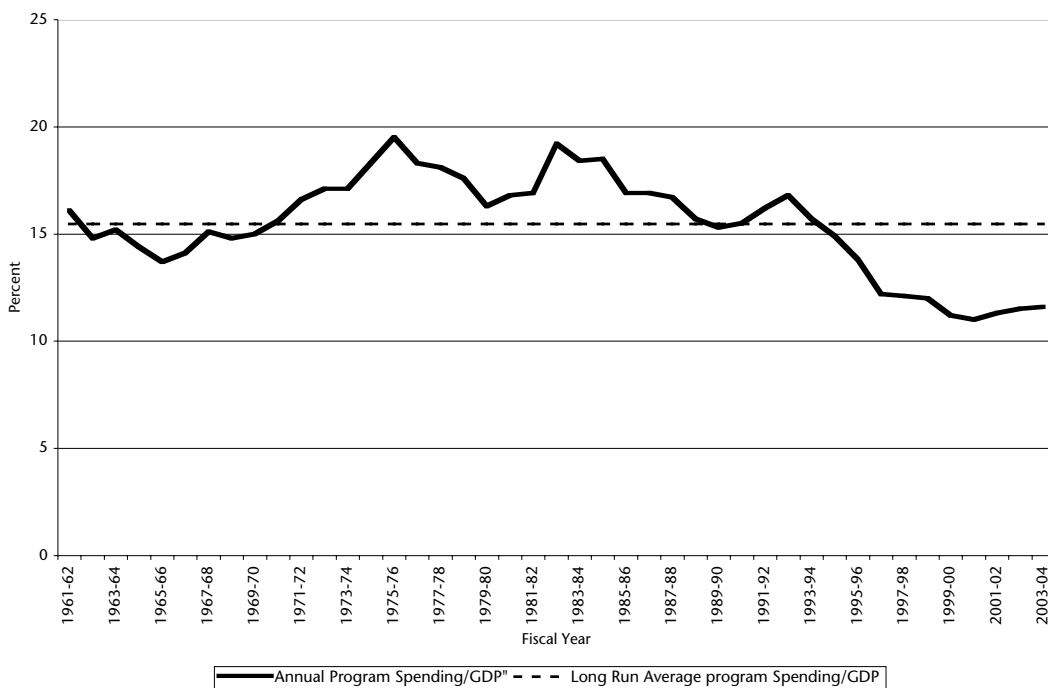
In nominal terms, program spending has grown from \$109.6 billion in 99/00 to \$141.4 billion in 2003/04. But this is an inappropriate indication of the growth in program spending because it ignores inflation and population growth. Some of the increased government spending represents the growth that is necessary just to keep pace with inflation, and some of it represents the additional spending required to provide the existing level of government services to a larger population.

To find a more appropriate means of comparing spending in 1999/00 with spending in 2003/04, we adjust the spending in 1999/00 for inflation and population growth. This adjusted figure represents what it would cost to provide the 1999/00 level of government services to the 2003/04 population in 2003/04 dollars. When this figure is compared with program spending in 2003/04, we find that program spending has grown in real per capita terms by just a little under 3.9% per year. This growth in spending is a modest beginning toward rebuilding the program spending chopped over the last 10 years, but it is hardly an explosion in spending.

In a forthcoming publication the CCPA will argue that this growth in program spending has not been sufficient to fulfill the spending promise embodied in its so-called "50/50 commitment" (the promise that half of the fiscal dividends from eliminating budget deficits would be used for program spending, and half debt repayments and tax cuts).

We can put the government's spending record into perspective by referring to statistics published in the government's fiscal reference tables concern-

Figure 1
Program Spending/GDP 1961-62 - 2003-04



ing program spending relative to Gross Domestic Product (GDP). This measure is used to illustrate the size of government spending⁴ relative to the economy. Because it is not a dollar figure, this measure has the added virtue of not being distorted by the impacts of inflation.

Program spending relative to GDP in the last few years is still lower than it has been at any time since the 1960s. Despite a small up-tick in program spending/GDP in 2002/03 and 2003/04, the government would have to spend a lot more just to achieve the level of program spending/GDP that existed in the year that deficits were eliminated. In 1997/98, the first year of a federal budget surplus, the government spent at a level of 12.1% of GDP⁵. The government would have had to spend an additional \$5.7 billion in 2003/04 to be comparable (relative to our economy) to what the spending level was in 1997/98.

Even if the federal government were to spend \$36.6 billion in future budget surpluses, this would increase program spending-to-GDP ratio to between 12.5 to 12.6% per year—still considerably less than the long-run average program spending/GDP ratio of 15.5%. By comparison, it is still well short of the 14.8% program spending/GDP ratio average that prevailed during the 1960s.

We conclude that government spending has not been restored to levels that would justify dissipating future surpluses on tax cuts or debt repayment. The surpluses posted in recent years represent a decision on the part of the Chrétien and Martin governments to repay debt and cut taxes in lieu of repairing the effects of the spending cuts which were enacted to balance the budget in the mid-1990s. Reinvestment in program spending has still been far too modest.

Conclusion: Surplus—What Surplus?

A genuine surplus implies that revenues exceed expenses. A surplus created by merely neglecting to pay for deficits in terms of addressing infrastructure, poverty, the environment and many other issues does not represent a situation in which the government has money that is in excess to its requirements. In this sense, recent federal surpluses are deceiving.

If the federal government is to repair the consequences of its decade of spending cuts and address new priorities such as early learning and childcare it does not have the fiscal capacity to consider a widespread tax cut agenda⁶ or debt repayment. As long as widely acknowledged spending priorities are left unmet, the federal surplus is, in our opinion, a pseudo-surplus created by the federal government's neglect of its rightful responsibilities.

Endnotes

- ¹ Michael Mendelson, "Playing the numbers for the great budget debate" *Globe and Mail*, Tuesday, September 7, 2004.
- ² <http://www.td.com/economics/qef/qefsep03.pdf>
- ³ This is likely an overstatement of future debt charges in that it does not reflect the \$9.1 billion surplus used to retire debt at the end of fiscal 2003/04.
- ⁴ This ratio concerns only government spending on programs; debt service payments are excluded.
- ⁵ 1997/98 (the year the deficit was eliminated) was a year in which program spending of 12.1% of GDP was already considerably below the long term average of 15.5% of GDP.
- ⁶ This does not preclude the federal government embracing certain targeted tax cuts that meet priorities that might otherwise be met through spending. For example, we endorse Campaign 2000 proposal to enhance the Canadian Child Tax Benefit to address child poverty.



CCPA

CANADIAN CENTRE
for POLICY ALTERNATIVES

CENTRE CANADIEN
de POLITIQUES ALTERNATIVES

410-75 Albert Street Ottawa, ON K1P 5E7

tel: 613-563-1341 fax: 613-233-1458

email: ccpa@policyalternatives.ca

<http://www.policyalternatives.ca>