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Is This the End of the Era of Large Federal Budget Surpluses?

Backgrounder for the 2004 Federal Budget

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Is the era of large budget surpluses is at an end? In anticipation of tomorrow's federal budget, this Behind the Numbers performs an experiment with the government's own numbers to generate an indication of the likelihood of future federal budget surpluses.

Our intent in this experiment is not to dispute whether the government's numbers are accurate. Indeed, since the CCPA's estimate of the current budget surplus is $8.3 billion, we obviously differ from the government in our assessment of what the real numbers are. But even WITH their numbers, we can show that large federal budget surpluses are not likely to go away.

Our methodology is as follows: First, we adopt cautious macroeconomic assumptions. Second, we generate a scenario that is consistent with the government's public pronouncements concerning a $5.2 billion surplus (at least) this fiscal year. Finally, using plausible assumptions about government revenue and taxation, we derive projections of future budget surpluses.

Step 1: Employing Cautious Macroeconomic Variables

Table 1 shows our macroeconomic variables. Note that we used a very pessimistic forecast for real GDP growth (2.2% for 2004 and 3.0% for 2005)[1]. This forecast is much more pessimistic that the growth rates assumed in the government's Economic and Fiscal Update (EFU). The Bank of Canada's Monetary Policy Report Update was considerably more optimistic (2.75% for 2004 and 3.75% for 2005). We accept the EFU's GDP inflation projections as stated.

For 2003/04, we adopt the EFU's estimated cost of servicing the public debt at $36.2 billion in the current fiscal year. We acknowledge that our estimate of this expense is likely high, since the Fiscal Monitor indicates that federal debt service payments have benefited from lower interest rates. We also make the conservative assumption that future debt service payments stay at the $36.2 billion level[2]. For the purpose of this exercise, we do not assume that budget surpluses are applied to pay down federal debt, thus we do not assume that

Table 1: Macroeconomic Indicators (in calendar years)

	2003	2004	2005	2006
GDP inflation[1]	3.30%	1.40%	1.90%	1.80%
Real GDP growth[2]	1.70%	2.20%	3.00%	3.00%
Total nominal GDP growth	5.00%	3.60%	4.90%	4.80%

Sources:
[1] Economic And Fiscal Update, 2003
[2] Statistics Canada (2003), Scotiabank Forecast Update (2004/05), Economic And Fiscal Update (2006) (estimates for 2005 and beyond)

the government will save money in future debt service charges as a result of debt repayment.

Step 2: Accounting For A $5.2 Billion Surplus In The Current Fiscal Year

We start with the assumption that the government surplus for 2003/04 is $5.2 billion, although this is likely an underestimate[3]. Since November's Economic and Fiscal Update projected a $2.3 billion surplus, we must account for this discrepancy. We make the reasonable assumption that, as of November, the government was in a position to be relatively accurate about its program expenditures and debt servicing costs. Thus we attribute this increase in the estimated surplus to increased revenue. This is consistent with the Finance Minister's claim that higher-than-expected corporate income tax revenue improved federal finances this year. To generate a surplus of $5.2 billion, revenue would have to be $2.9 billion higher than was estimated in the November Update, or $183.5 billion.

Step 3 : The Fiscal Outlook

Our final step is to make some assumptions about future government revenue and expenditure behaviour.

1) Tax Revenue

For fiscal year 2003-04, we derived a revenue estimate of $183.5 billion, which constitutes a revenue-to-GDP ratio of 15.1%. For the purposes of this exercise, we assume that this ratio will remain constant in future years. However, this is an historically low level of tax revenue relative to GDP (the revenue share has not been this low since 1978/79). Even since the implementation of tax cuts starting in the year 2000, the tax/GDP ratio has so far not fallen below 15.4%.

2) Program Spending

Following the recent Treasury Board estimates, we assume that program spending will be $147.1 billion, which amounts to an 11.7% program spending /GDP ratio, and that the government will continue to spend at this same rate in the future[4].

Are Budget Surpluses Threatened?

Using the above methodology, our calculations indicate that federal budget surpluses are likely to persist. As illustrated in Table 2, over the three-year period to 2006-07, we project a surplus of $6.8 billion in 2004/05, $8.9 billion in 2005/06, and $11.1 billion in 2006/07.

Table 2: Fiscal Outlook for the Federal Government

	2001-02 actuals	2002-03 actuals	2003-04 estimate	2004-05	2005-06	2006-07
Budgetary Transactions (fiscal years)						
Revenue	171.7	177.6	183.5	190.1	199.4	209.0
Program Spending	125	133.3	142.1	147.1	154.3	161.7
Debt Service Expense	39.7	37.3	36.2	36.2	36.2	36.2
BUDGET BALANCE	7.0	7.0	5.2	6.8	8.9	11.1
Federal Debt	517.5	510.6	510.6	510.6	510.6	510.6
Budgetary indicators as percentage of GDP						
Rev/GDP	15.5%	15.4%	15.1%	15.1%	15.1%	15.1%
Program Spending/GDP	11.3%	11.5%	11.7%	11.7%	11.7%	11.7%
Debt/GDP	46.7%	44.1%	42.0%	40.5%	38.6%	36.8%

Accrural method of accounts used, all dollar amounts in billions.

Despite the conservative assumptions we have adopted—which in fact may understate potential future budget surpluses—our projections show a budget surplus of $26.8 billion between 2004/05 and 2006/07. As Table 2 indicates, the government could spend these surpluses on programs rather than paying down debt, and the debt/GDP ratio would still decline substantially.

Contrary to current government rhetoric, the federal cupboard is far from bare.

Endnotes

1 Forecast Update, Scotiabank, March 3 2004.

2 Since much of the debt is long-term, even if interest rates do increase, there is a delayed effect of these interest rate increases on the cost of servicing the federal debt.

3 On February 11, the Fiscal Monitor announced that the budgetary surplus for the period April to December 2003 was $5.2 billion. Since this budget surplus divides out to $1.7 billion per quarter during the first three quarters of the fiscal year, it is tempting to assume that this performance will continue and the final budget surplus for 2003/04 would be $6.9.

4 This is consistent with the assumption made by the government in its Economic and Fiscal Update, in which it projects that government spending/GDP would amount to 11.6% between fiscal year 2004-05 and fiscal year 2007/08.

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