Federal Fiscal Forecasting Round 2: Post-Budget Update

March 31, 2005

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For the House of Commons
Standing Committee on Finance

I. From "Update" to "Budget"

For the first round of independent fiscal forecasts performed for the House of Commons Standing Committee on Finance, the participating economists were asked to evaluate the base-case fiscal projection for the federal government on the basis of the November 16, 2004 *Economic and Fiscal Update*, as modified by subsequent budgetary announcements and macroeconomic developments. The November update emphasized that federal finances were relatively tightly balanced, particularly in the coming two fiscal years. The update projected surpluses (for "planning purposes") of less than $1 billion in each of 2005-06 and 2006-07, and only a modest planning surplus (of $3 billion) in 2007-08. On this basis the Finance Minister warned against expectations of significant spending or tax cut initiatives – at least not in the medium-term.

In our first submission to the Finance Committee's fiscal review exercise,[1] the Canadian Centre for Policy Alternatives suggested that underlying federal surpluses were much larger than implied in the November update, and that official Finance Canada projections were continuing past practices of underestimating federal revenues and overestimating the federal government's interest costs. More reasonable projections of federal revenues and interest costs generated projected surpluses averaging over $10 billion during the fiscal years 2004-05 through 2006-07, even after adjusting for the fact that economic growth was then expected to be somewhat weaker than had been anticipated at the time of the Update.

Immediately following the submission of that first round of fiscal reviews, Finance Minister Ralph Goodale unveiled his 2005 budget. This budget contained a broad range of significant new tax and spending initiatives, totalling close to $50 billion between fiscal 2004-05 and 2009-10 (including several billions of dollars of new spending and tax cuts during the same years – 2005-06 and 2006-07 – in which the government's fiscal situation had been expected to be especially tight).[2]

A total of 99 days elapsed between the November 16 update and the February 23 budget. During this period of time, apparently, the federal government's fiscal situation evolved rapidly – from famine to feast. How could a government which was warning against expansive budgetary expectations suddenly locate sufficient resources to support almost $50 billion worth

[1] Jim Stanford, *Federal Fiscal Forecasting: Pre-Budget Update*, Canadian Centre for Policy Alternatives, February 22, 2005.

[2] The summary of budget initiatives ($48.9 billion in total) reported on p.26 of the budget does not differentiate clearly between spending and tax measures. We can estimate that categorization, however, in the following manner. Adjust the pre-budget fiscal projection reported by the government in its November update, with the post-update changes to the government's "base-case" fiscal situation reported in Table 7.3 of the budget. This is an adjusted base-case forecast, prior to the initiatives announced in the budget. Comparing that adjusted base-case to the actual fiscal projections in Table 7.6 provides separate estimates of the value of new program spending ($35 billion over the years 2004-05 through 2009-10, *before* deducting expected ERC savings) and tax reductions ($14 billion over the same period). By this reckoning, 70 percent of the value of all the new initiatives announced in the budget consisted of new spending, while 30 percent went to tax reductions. However, after netting out the expenditure reductions anticipated to result from the ERC, then there are only $42 billion worth of new initiatives – two-thirds of which consist of new program spending.

of new spending and tax initiatives? The Finance Committee's independent fiscal review exercise is motivated in part by a desire to construct a more transparent and neutral understanding of the federal government's fiscal condition. Reconciling the evolution of the official Finance Canada forecast – from the November update to the February budget – may hence provide some useful insight into the nature and dimensions of the fiscal forecasting errors which have undermined the credibility of official Finance Canada projections.

The top portion of Table 1 calculates the total incremental resources which had to be identified by the federal government in order to support the announcements contained in the 2005 budget. Those initiatives (consisting of both new spending and tax reductions) are projected to consume $48.9 billion in fiscal resources between 2004-05 and 2009-10.

What made this task all the more challenging is that Canada's macroeconomic prospects actually weakened somewhat between the update and the budget. By the time of the budget, real GDP growth was expected to be 0.3 percentage points slower in both fiscal 2004-05 and 2005-06, than had been expected at the time of the update. The negative budgetary implications of this real economic slowdown were partly offset by the fact that GDP inflation is now expected to be slightly faster than the previous forecast (so that the shortfall in nominal GDP is not at large as the shortfall in real GDP), and interest rates will be somewhat lower in the medium-term (reducing the government's interest costs). On the basis of the macroeconomic sensitivity parameters assumed by Finance Canada (reported in Table 7.4 of the budget), the negative evolution of the macroeconomic environment between the update and the budget should have reduced the government's net fiscal position by over $3 billion over the forecast period (2004-05 through 2009-10). The components of this overall impact are described in more detail in Table 2. Given the modest deterioration in the expected macroeconomic environment, the government had to therefore mobilize an even larger sum of resources to fund the ambitious initiatives unveiled in the budget. In addition, Table 7.3 of the budget indicated that the government now believes the cost of existing programs (such as EI benefits) will be slightly higher than was anticipated at the time of the update, by a total of $2.2 billion over the period 2004-05 through 2009-10.

These three items together implied the government had to identify $54 billion in gross resources over the entire forecast period. Against this, the government could invest the projected planning surplus that was reported in the November update: a total of $29.5 billion over the period from 2004-05 through 2009-10. This left a funding gap of almost $25 billion over the forecast horizon which the government had to close in order to pay for the announced set of initiatives. How did the government locate $25 billion in new resources, during the 99 days that elapsed between the update and the budget?

Less than one-third of those resources are expected to come from the expenditure savings that are to be identified and captured by the Expenditure Review Committee (ERC). These savings are reported to total a net $7.1 billion over the forecast period. A helpful "smoothing" of the government's fiscal profile was accomplished through the decision to "pre-book" $3.6 billion in provincial transfer payments (associated with the waiting list reduction initiative). This had the effect of shifting excess resources from fiscal 2004-05 to later years. Close to $5 billion in additional savings are identified in the budget from lower debt service charges than were

expected in the update. It is worth noting that these interest cost savings are significantly greater than can be attributed directly to the reduction in the expected path of interest rates. On the basis of the assumed interest rate sensitivities reported in Table 7.4 of the budget, the reduction in the interest rate forecast from the update to the budget can only explain about $3.5 billion in the total interest rate savings now expected over the forecast period (comparing the update's projection to the budget's). The remaining $1.5 billion in lower interest costs seems to reflect a recognition that interest costs were significantly overestimated in the initial update projection (as has been Finance Canada's systematic past practice).

The combination of ERC savings and lower interest costs still leaves unidentified a majority of the new resources required to support the budget's tax and spending initiatives. The government still needed to locate an incremental $12.8 billion in revenues, out of the $24.7 billion that needed to be "found" in total. To this end, the government essentially acknowledged that its base-case revenue forecast contained in the November update (like previous projections) was far too low. In the February budget, therefore, it explicitly boosted that base-case revenue forecast by $9.9 billion over the forecast horizon – and this was despite the macroeconomic slowdown which should have *reduced* that tax take, not increased it. Behind-the-scenes of its fiscal projections, the government in effect "discovered" an additional $2.9 billion in revenues to offset the overall net fiscal impact of the reduction in its economic forecast between the update and the budget. This implies that the government boosted its overall revenue projection by a total of $12.8 billion over the whole forecast horizon.

The February budget contains some discussion and justification for this suddenly more optimistic projection of the federal government's revenue base (see especially pp. 246-249 of the budget). But given the long-standing pattern of official underestimation of federal revenues, and the evidence which was readily available even at the time of the update that federal revenue growth was much stronger than implied in that update, it is difficult to believe that this upward revision in the fundamental drivers of federal revenues was truly a "surprise," conveniently discovered by Finance Canada officials sometime in the 99 days between the update and the budget. A more reasonable explanation of this evolution in thinking is that the federal government felt politically compelled to incorporate a more reasonable revenue projection into its budget. This compulsion was rooted mostly in the requirement, in conditions of minority government, to strengthen the government's base of popular support with favourable spending and tax announcements. As the government began to experience this political pressure more acutely, it decided to "tap" into the disguised fiscal reserves that were implicit in the update's unduly pessimistic revenue projections (and, to a lesser extent, its overestimations of interest costs). In this sense, minority government has produced a modest improvement in the "honesty" of the government's fiscal projections (although, as will be discussed below, there is considerable distance still to travel in this regard).

It is striking that more new resources were identified by revisiting previous pessimistic revenue projections ($12.8 billion in total), than are expected to be freed up through the government's much-vaunted expenditure review exercise ($7.1 billion). In other words, becoming more "truthful" in its revenue forecasts generated 80 percent more "new" resources that will be generated by the effort to shave costs from existing federal programs. This makes

one wonder how many additional resources could still be "discovered" – simply by revisiting the continuing conservative bias in federal projections.

Two other changes in the base-case fiscal outlook presented in the 2005 budget also deserve commentary. For the first time in several years, the budget presented a longer-term fiscal projection – stretching out five fiscal years into the future, instead of just two (as has been the recent practice). This reform, too, was politically convenient, in that it allowed the federal government to announce several significant but deferred initiatives (such as those tax reduction measures which take effect in 2008 and later).

Similarly, the government's decision to "pre-book" $3.6 billion in provincial transfer expenses related to its waiting-list initiative was convenient: it allowed the government to shift some fiscal room from 2004-05 (when even the Finance Minister acknowledged a large surplus) to later years (when the fiscal situation was portrayed as being considerably tighter). In effect, the government sequestered a portion of the large surplus for 2004-05, during the "dying days" of that fiscal year, to fund subsequent initiatives. This follows the precedent set by similar budgetary tactics in past years (such as one-time endowments of independent agencies, scholarship programs, and other initiatives) which also permitted Ottawa to spread fiscal "windfalls" over subsequent years. It particularly casts serious doubt on the government's long-standing claim that it is legally bound to allocate large year-end surpluses only to debt reduction. By its actions, the government has proven that when it *wishes* to allocate large year-end surpluses to other priorities, budgetary practices are indeed sufficiently flexible for this to occur. If government chooses not to allocate year-end surpluses to pressing priorities (like child care, environmental protection, or urban infrastructure) it is because it has chosen not to, not because its "hands are tied."

In summary, a striking evolution occurred between November and February in the official Finance Canada projection of the federal government's base-case fiscal situation. Many billions of dollars in "new" resources were identified just in time for the February budget, despite a deterioration in the macroeconomic assumptions that underlie the budget. By mobilizing large sums from previously underestimated revenues (supplemented by smaller sums in overestimated interest costs), the government was able to locate sufficient resources to support its numerous expensive budget promises. As will be discussed below, the official projection is still unduly conservative: true budget balances are likely to be several billion dollars per year larger than projected in the 2005 budget. But this budget did go some way toward recognizing the true strength of the federal government's fiscal circumstance – certainly more than have recent projections. In so doing, the budget implicitly confirmed that past Finance Canada errors in underestimating revenues and overestimating interest costs were highly arbitrary. Once it became politically convenient (or, perhaps, necessary) for the government to revisit those systematically erroneous assumptions, it did so – with expansive results for its own bottom line.

II. Methodology

Similar to our first submission to the Finance Committee's fiscal review exercise, this fiscal forecast will adopt the following methodology:

- As was described in detail in our submission of February 22, 2005, errors in macroeconomic forecasts have not been the main source of errors in federal budget forecasts. So this review will simply compile a current "consensus" macroeconomic forecast based on the published forecasts of private-sector Canadian economists. This "consensus" will form the basis of our own independent fiscal forecast.

- Federal revenues are separately projected in seven major categories (personal and corporate income taxes, GST revenues, EI premiums, customs duties, energy-related excise taxes, and other), on the basis of the consensus macroeconomic forecast and demonstrated historical relationships between the revenue categories and selected macroeconomic variables.

- The forecast separately projects two components of program spending (seniors' benefits and EI benefits) which are predictably related to macroeconomic flows. For provincial transfer payments and other federal spending (on direct federal programs), our forecast utilizes the official projections as reported in the February 2005 budget.[3]

- Debt service charges are projected independently on the basis of the evolving net federal debt burden and trends in interest rates.

- An overall forecast budget balance is then projected on the basis of these components.

- The entire forecast exercise reflects a "status-quo" policy base case: other than spending announcements and tax changes announced at the time of the February budget, no policy changes are assumed.

- To be consistent with other forecasters, it is assumed that federal budget surpluses are "sterilized," over and above a repayment of $3 billion in debt per year (equal to the annual $3 billion contingency fund). This implies that net federal debt (and hence future interest costs) does not fall as quickly as would be the case if surpluses were indeed generated according to the forecast below. In this important sense, our fiscal forecast is conservative: actual interest costs are likely to decline faster than indicated in this forecast, if the government continues to allocate some or all of its incremental surpluses (above the $3 billion contingency fund) to debt repayment. In fact, by 2009-10, if the government allocated the full anticipated surpluses to debt repayment (not just $3 billion per year), its closing net debt would be almost $50 billion lower than indicated in our forecast, and its interest costs almost $3 billion lower.

[3] With no access to interim data on program expenditures or on detailed intra-year program spending budgets from Finance Canada, it is not possible for independent forecasters to make any informative judgement on these other, more discretionary program spending categories. Thus, our forecast must accept the official budgets for these spending areas as given.

- Table 5 of our forecast reports a "true" estimate of the expected federal surplus in each year. For comparison purposes, it also reports an estimate net of the deduction of the annual $3 contingency reserve and the escalating cushion for economic "prudence" that represent the current Finance Canada budgeting methodology. This latter balance is comparable to Finance Canada's "surplus for planning purposes."

- The 2005 budget provided a fiscal projection that stretched out to 2009-10 – three years longer than its recent practice. Our forecast presents a complete fiscal statement for the coming two fiscal years (2005-06 and 2006-07), as contracted with the Standing Committee on Finance. But we also present a preliminary fiscal projection for the subsequent three years (corresponding to the budget's new longer-run projection). This longer-run projection is based on a "baseline" macroeconomic path (not actual economists' forecasts, which typically do not extend more than two years into the future), described below; it should be interpreted with caution, since it is entirely dependent on that assumed underlying macroeconomic baseline.

III. Consensus Macroeconomic Forecast

Table 3 reports the major components of a "consensus" macroeconomic forecast that was compiled by reviewing the current expectations of ten forecasts or surveys of forecasts of the Canadian economy, all published since January 1.[4] In each case a median value is chosen for the consensus variable. For nominal GDP, a consensus median is adopted considering both those forecasts which directly forecast nominal GDP growth, and those which forecast GDP inflation (hence generating an implied growth rate of nominal GDP). This is then converted into a separate but consistent forecast of GDP inflation. The unemployment rate forecast reported is implied by the forecast growth of employment combined with assumptions regarding labour force growth that are noted in Table 3.

Compared to the macroeconomic forecast that underpins the February 2005 budget (summarized on p. 62 of that document), this current consensus reflects the continuing downward evolution of Canadian economists' forecasts. The appreciation of the Canadian dollar is exacting a significant toll on Canada's exports; this dampening effect was confirmed by the fourth-quarter GDP estimates (released after the budget) and by more recent monthly data on employment, international trade, and manufacturing shipments. Both real GDP and employment growth are now expected to accelerate somewhat in 2006. Interest rates (both long-run and short-run) are expected to hold their current levels for most of the coming year, followed by a gradual rise in 2006.

In summary, the evolving consensus among Canadian economists contains a balance of moderately "bad" news for the federal fiscal balance. Real GDP growth will be a little bit slower in 2005 than was expected several months ago; the impact of this on the federal budget balance

[4] Not all of the forecasts report each of the variables reported in Table 3, hence the sample size for some variables is smaller than 10.

will be partly offset by higher-than-expected GDP inflation in 2004 and 2005, and lower-than-expected interest rates.

The calendar-year consensus forecast summarized in Table 3 is converted into a forecast that is appropriate for projecting fiscal year variables, as indicated in Table 4.

The last column of Table 3 reports the "baseline" macroeconomic scenario which is utilized for the preliminary longer-run fiscal projections contained in this report (for 2007-8 through 2009-10). This baseline scenario reflects a steady-state equilibrium in which real growth matches commonly-estimated rates of growth of potential output in Canada, and both GDP and CPI inflation are at the middle of the Bank of Canada's target band. It is very similar to the long-run (2007-08 to 2009-10) average forecast contained in the February budget.

IV. Six-Year Federal Fiscal Forecast

On the basis of the consensus macroeconomic forecast indicated in Tables 3 and 4, a projection of the main features of the federal budget is developed, covering the six fiscal years from 2004-05 through 2009-10. It should be stressed again that the projections for the years 2007-08 and afterward are extremely general, given the absence (as discussed above) of a detailed or reliable consensus macroeconomic forecast for those years. On the anticipation of continued growth within the normal range of estimates of the Canadian economy's potential output, however, the broad fiscal parameters likely to face the government in those years can be described, with the caveat that the latter years of this projection must be interpreted very cautiously.

Table 5 reports the summary of federal fiscal transactions, in both dollar terms and as shares of GDP. Tables 6 and 7 provide detailed breakdowns of the major revenue and spending categories, and a line-by-line comparison of our forecast to the February 2005 budget. The main features of our forecast are as follows:

- Federal revenues remain generally stable as a share of GDP – at slightly below 15 percent of GDP – until 2008-09. Beginning in 2008-09, however, the revenue share declines by about one-half of a percentage point over the next two years, reflecting the deferred implementation of the personal and corporate income tax reductions announced in the February budget.

- We expect that federal revenues will be significantly higher than projected in the budget, by $6 billion per year in both 2005-06 and 2006-07. As discussed above, we believe that Finance Canada officials have become significantly more "aggressive" in their revenue forecast (in order to identify sufficient resources to fund the significant initiatives announced in the budget). Nevertheless, those revenue projections are still on the conservative side.

- Without substantial tax cuts (none of which are in store in the federal government's plan until 2008 and beyond), there is no convincing reason to expect a significant decline in the government's revenues as a share of GDP. The smaller tax cuts which are being implemented before 2008 (including the final phasing out of the federal capital tax, and the

initial increases in the basic personal income tax exemption) only offset the remaining mild upward "creep" in tax revenues relative to GDP (which results from factors such as the pro-cyclicality of corporate income tax revenues, increases in real personal incomes which push more Canadians into higher tax brackets, and the gradual erosion in the importance of the GST tax credit relative to the overall intake of GST revenues). Stability in the overall federal revenue share, combined with the consensus macroeconomic forecast described below, implies that actual revenues are likely to significantly exceed the February budget projections in the coming two fiscal years.

- This gap between official projection and likely reality ($6 billion per year, underestimating revenues by about 3%) is somewhat smaller than the consistent underestimation of federal revenues which has been the crucial source of federal budget errors over the past decade.[5] Nevertheless, this unduly pessimistic forecast of revenues remains the key source of the budget's overall bias toward the surplus side of the ledger.

- In later years, the extra revenue forecast in our projection shrinks gradually, falling to $3.5 billion (or just 1.5% of revenues) by 2009-10. This provides further evidence for the proposition that Finance Canada officials were relatively more "aggressive" in their revenue forecast for those further-out years – likely motivated, again, by the need to identify and allocate sufficient resources to pay for the more significant tax reductions which would come into effect in 2008 and 2009.

- We expect federal program spending to come in essentially "on budget." We expect that seniors' benefits will be slightly higher than projected in the budget, and EI benefits will be somewhat lower. (The budget assumes a substantial increase in the proportion of unemployed Canadians who qualify for EI benefits; unfortunately, however, there is insufficient reason, given the current EI policy framework, to accept this assumption.) By assumption, we have utilized Finance Canada's own projections of transfer payments to governments and direct program expenditures – since we have no independent ability to assess those projections.

- Debt service charges in 2004-05 are projected as equal to the estimate contained in the February budget. For subsequent years, however, forecast interest costs are lower than expected in the budget. As discussed above, the budget "tapped" its previous unduly pessimistic projections of interest payments for some of the incremental resources it needed to finance its spending and tax initiatives. Only about two-thirds of those identified savings were "justified" by the reduction in the assumed level of interest rates; the rest reflected an ad-hoc adjustment in the overall scale of those payments. Despite this step towards greater honesty in its projection of interest costs, however, we continue to assess the budget's interest cost projection as too high. For the two years 2005-06 and 2006-07, we expect total interest costs (over the two years) to come in $1 billion lower than projected in the Budget. In subsequent years, the gap between our forecast and the budget projection increases in size

[5] As described in detail in Table 1 of our initial February 22 submission to the Finance Committee, every federal budget released since 1996 has systematically and significantly underestimated federal revenues, by an average of 5 percent over those eight budgets.

(partly because the budget, following past Finance Canada practice, assumes no debt repayment at all – consistent with the fiction that future budgets are only "balanced").

- For the just-ended current fiscal year (2004-05), we project a surplus of $3.9 billion – just slightly larger than the official contingency fund of $3 billion (which serves as the *de facto* budget target for the government). This indicates that most of the 2004-05 fiscal room above the $3 billion target has now been allocated to various initiatives, including the pre-funding of $3.6 billion worth of future health care transfers to provincial governments (assigned to the waiting list reduction initiative).

- This forecast that only a small "planning" surplus remains for fiscal 2004-05 may err, however, on the conservative side. Our fiscal projection model is rooted in historical relationships between GDP and its various components, and the major categories of federal revenues. However, interim data on federal revenues (reported by Finance Canada in its *Fiscal Monitor*) suggest that many categories of federal revenue have been more robust in the 2004-05 fiscal year than those historical relationships would suggest. This finding is illustrated in Table 8, which contains the presumed annual growth rates for 2004-05 for various revenue categories, as reported in the February budget, our own fiscal forecast, and in the first 10 months of data for fiscal 2004-05 from the *Fiscal Monitor*. It is obvious from this table that revenues in most categories were stronger over the first portion of 2004-05 than either the budget or our own projection would suggest. The *Fiscal Monitor* data must be interpreted with extreme caution, however: in past years, year-end adjustments and reconciliations have resulted in very large changes to the final *Fiscal Monitor* data. For this reason, we have chosen to continue to root our 2004-05 projection in the historical fiscal elasticities, not the more "bullish" relationships suggested by the *Fiscal Monitor* data. Nevertheless, there is some reason to expect that final revenues for 2004-05 may come in substantially higher than projected in both the budget and in our own forecast. This would allow the federal government to declare another "unexpected" year-end surplus (and this time, for a change, that surplus would indeed be a "surprise"). It would also result in a more expansive fiscal outlook for subsequent years, for two reasons: federal revenues would be starting from a higher initial point, and the 2004-05 experience may indicate that the fiscal elasticities rooted in historical data may in fact be too conservative.

- In coming years, the government continues to enjoy significant surpluses, far in excess of the official $3 billion contingency fund target. The "true" surplus grows to $11 billion in 2005-06 and $12 billion in 2006-07. Assuming the continuation of our "baseline" macroeconomic scenario, the surplus would then stabilize at about $13 billion in the three following years (2007-08 through 2009-10).

- Even after deducting the annual contingency fund and indicated reserves for "economic prudence" (if Parliament should decide that these hyper-cautious practices remain a necessary feature of budget-making, even though Canada now ranks as the least-indebted major industrial country in the world), the government enjoys approximately $7 billion in additional fiscal room (the so-called "surplus for planning purposes") in each of the coming five years. In contrast, the February budget formally reported that its planning surplus has been completely depleted to pay for the various tax and spending initiatives that it

announced; in the budget, projected surpluses are sufficient only to perfectly offset the contingency and prudence cushions.

- Most previous budget forecasts tended to identify an underlying surplus that grows substantially over time, thanks to the pleasant fiscal effects of a declining relative debt burden (and hence declining relative interest payments). In the current projection, however, the underlying surplus stabilizes in 2007-08 and beyond (at about $13 billion per year). This indicates that the significant deferred tax reduction and spending initiatives announced in the February budget (many of which will be implemented beginning in 2008 and beyond) have already captured the incremental fiscal resources which will be freed up after that point. Nevertheless, over the entire forecast period (2005-06 through 2009-10), it is clear that the federal government retains significant excess fiscal room which can be allocated to new spending or tax reduction priorities.

The detailed decomposition of revenue and spending estimates reported in Table 6 indicates some additional features of interest in our forecast:

- There is one significant difference between our forecast and the official budget projection regarding the *composition* of federal revenues. We believe that the budget has significantly underestimated corporate income tax revenues – even after adjusting for the value of coming corporate tax reductions (both those announced in previous budgets and still being enacted, and the additional corporate tax cuts that were announced in this budget). Corporate profits have reached record levels (in both dollar terms and as a share of GDP), yet this is not reflected in the official projection. At the same time, the official projection may overestimate personal income tax revenues: the record-breaking expansion of corporate profits as a share of GDP is inevitably reflected in a decline in the share of GDP which finds its way into personal income, and this may serve to depress personal income tax growth below the levels anticipated by the budget. The two effects are largely offsetting.

- GST and EI premium revenues are expected to be quite close to the budget projections.

- "Other" federal revenues are projected to be significantly higher than expected in the budget. The "other" category received a one-time boost in 2004-05 due to the inclusion of the $2.6 billion gain from the sale of the federal government's remaining portion of Petro-Canada; this one-time gain, of course, will not be repeated. But the February budget projection implies a substantial erosion in other revenues as a share of GDP, even compared to a revenue base which excludes the Petro-Canada proceeds. No particular justification is provided for this pessimistic assumption. Assuming more stability in "other" revenues provides the more optimistic forecast for this category contained in Table 6.

Figure 1 illustrates the longer-run evolution of the major federal budget categories. The figure highlights the ongoing convergence between revenues and program spending; this convergence is facilitated by the gradual decline in debt-service charges as a share of GDP (visible at the bottom of Figure 1). The erosion of debt-service charges reflects the shrinking

relative importance of net debt (relative to both GDP and to overall federal revenues).[6] Over time, smaller debt service charges allow new allocations to either new program spending initiatives or tax reductions. This is the arithmetic behind the so-called "fiscal dividend" which has made federal budget-making a more enjoyable experience in recent years. As is visible from Figure 1, most of the movement in the budgetary "convergence" has occurred via a decline in the revenue share (which will have fallen by almost 3 points of GDP by 2009-10 compared to 2000-01 levels, versus an increase of slightly over 1 point of GDP in program spending during the same period). This disproves the current judgement of some conservative commentators that the federal government is on a "spending spree." Clearly, tax reductions have captured the lion's share of new resources which the government has allocated in recent years.

By 2009-10, the government will have allocated half of the total "fiscal dividend" that could conceivably be reaped, since by then debt service charges will have been cut in half relative to their levels in 2000. Moreover, remaining incremental resources will be freed up more slowly than in previous years, since the debt ratio will decline more slowly relative to GDP than it has since 1996. In this context, it is especially important that wise decisions are made by government regarding how freed-up resources are allocated, since it will only be for a few more years that government will have the pleasure of allocating substantial new resources with each passing budget.

V. Analysis and Conclusions

In its February budget, the federal government took a cautious step towards more honesty in its budgeting practices. Driven by a political need to find resources to fund substantial new initiatives on both the program spending and the tax sides of its ledger, Finance Canada officials revisited its traditional highly pessimistic projections of revenues and, to a lesser extent, interest costs. Lo and behold, the government was able to locate many billions of dollars by revisiting its assumptions in these two categories, which it put toward the expensive initiatives announced in the budget.

However, the fiscal projections of the February 2005 budget are still unduly pessimistic. We find that the budget continues to underestimate likely actual federal revenues by about 3 percent (or about $6 billion per year) over the next two fiscal years. This is smaller than the average revenue errors which marked recent budgets (which underestimated revenues by an average of 5 percent since 1996), but still creates a substantial and artificial cushion underlying the federal budget. The budget also continues to overestimate likely interest costs – again, by a smaller but still significant margin. These factors convince us that the February budget is still underestimating the true strength of the federal government's fiscal position. In reality, on the basis of the current "consensus" forecast of macroeconomic growth, the government will experience surpluses in excess of $10 billion in each of the coming two fiscal years. And if the Canadian economy continues to follow the "baseline" scenario outlined in Table 3, those large surpluses will continue.

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[6] About 85 percent of this erosion is due to the growth of GDP; only about 15 percent is due to actual debt repayment.

Table 1
Reconciliation of November Update with February Budget

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	6-yr Total
Need for New Resources:							
Budget Initiatives[1]	3.0	3.4	5.3	7.9	12.6	16.6	48.9
Plus: Macroeconomic Loss[2]	0.4	1.0	0.4	0.6	0.5	0.2	3.2
Plus: Extra Program Costs[3]	0.7	0.3	0.4	0.4	0.2	0.2	2.2
Sub-total:	4.2	4.7	6.1	8.9	13.3	17.1	54.2
Less: EFU Planning Surplus[4]	5.9	0.5	0.9	3.2	7.5	11.5	29.5
TOTAL NEW RESOURCES	**-1.7**	**4.2**	**5.2**	**5.7**	**5.8**	**5.6**	**24.7**
Sources of New Resources:							
ERC Savings[5]	-0.3	0.5	0.9	1.7	2.1	2.2	7.1
Pre-Booked Waiting List[6]	-3.6	0.6	1.2	1.2	0.6	0.0	0.0
Debt Service Savings[6]	0.0	0.8	1.4	0.9	0.9	0.9	4.9
Of which: "legitimate"[7]	0.0	0.5	0.9	0.6	0.5	0.5	3.0
New Revenues	2.1	2.4	1.7	1.9	2.3	2.4	12.8
Of which: above EFU base[8]	1.8	1.4	1.2	1.4	1.8	2.3	9.9
Residual: to get back to EFU base[9]	0.3	1.0	0.5	0.5	0.5	0.1	2.9
TOTAL NEW RESOURCES	**-1.7**	**4.2**	**5.2**	**5.7**	**5.8**	**5.6**	**24.7**

1. Budget Table 1.2.
2. Author's calculations from macroeconomic sensitivity parameters (Budget Table 7.4) and indicated changes in macroeconomic assumptions since Fiscal Update (Budget p.62); details in Table 2.
3. Budget Table 7.3.
4. Economic and Fiscal Update Table 3.6.
5. Budget Table 1.2.
6. Difference between Economic and Fiscal Update Table 3.6 and Budget Table 7.6.
7. Author's calculations based on interest sensitivity parameters (Budget Table 7.4) and indicated reduction in interest rate assumptions (Budget p.62); details in Table 2.
8. Budget Table 7.3
9. Balancing item.

Table 2
Fiscal Impact of Lowered Macroeconomic Assumptions

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	6-yr. Total
Change in Assumptions[1]							
Real GDP (%)	-0.3	-0.3	0	0	0	0	
GDP Inflation (%)	0.2	-0.1	0.1	0.2	0.2	0.2	
Change Interest Rates (b.p.)[2]	0	-45	-30	50	0	0	
Fiscal Impact[3]							
Real GDP	-0.8	-1.6	-1.7	-1.8	-2.0	-2.0	-9.8
GDP Inflation	0.3	0.1	0.3	0.6	1.0	1.3	3.6
Interest Rates	0.0	0.5	0.9	0.6	0.5	0.5	3.0
Total	**-0.4**	**-1.0**	**-0.4**	**-0.6**	**-0.5**	**-0.2**	**-3.2**

1. Difference between November 2004 and February 2005 assumptions, budget p.62.
2. Average of 3-month and 10-year interest rates. Only the difference in the *change* in interest rates matters; 2007-2009 change is assumed to occur entirely in 2007.
3. Cumulating fiscal impact of changes in assumptions, on basis of sensitivity parameters provided in budget Table 7.4.

Table 3
"Consensus" Macroeconomic Forecast (%)[1]

	February 2004 Budget			Current Consensus		"Baseline" Scenario
	2005	2006	2007-9	2005	2006	2007-9
Real GDP Growth	2.9	3.1	2.9	2.6	3.0	3.0
GDP Inflation	2.0	1.9	1.9	2.1	2.0	2.0
Nominal GDP Growth	4.9	5.0	4.8	4.9	5.1	5.1
3-month Interest Rate	2.7	3.5	4.6	2.5	3	3.5
10-year Bond Rate	4.6	5.1	5.6	4.6	4.8	5.0
CPI Inflation				1.8	1.9	2.0
Employment Growth	1.4	1.5	1.4	1.4	1.5	1.4
Unemployment Rate[2]	7.2	7.0	6.7	7.1	7.0	6.9
US Real GDP Growth	3.6	3.4		3.5	3.4	

1. Median values of 10 published forecasts for 2005 and 2006; steady-state "baseline" scenario for later years.
2. Forecast and baseline scenario derived from employment growth forecast on assumption of 1.3% annual growth in working age population and constant participation rate.

Table 4
Calendar Year to Fiscal Year Forecast Conversion

	Calendar Years (Consensus Forecast)		Fiscal Years	
	2005	**2006**	**2005-06**	**2006-07**
Real GDP Growth	2.6	3.0	2.7	3.0
GDP Inflation	2.1	2.0	2.1	2.0
Nominal GDP Growth	4.9	5.1	4.9	5.1
Nominal GDP ($t)	1.356	1.425	1.373	1.442

Assumes forecast annual calendar-year growth rates for real and nominal GDP are experienced equally in all calendar-year quarters.

Table 5
Summary Statement of Transactions

	2004-05	2005-06	2006-07	2007-08[2]	2008-09[2]	2009-10[2]
Billions $						
Revenue	196.2	206.6	216.1	225.7	232.9	241.3
Program Spending	157.7	160.9	168.9	177.2	184.9	193.5
Debt Service[1]	34.7	34.5	34.7	35.0	34.8	34.6
"True" Balance	3.9	11.2	12.4	13.5	13.1	13.3
Contingency/ Prudence	3.0	4.0	5.0	6.0	6.5	7.0
Balance After Contingency/Prudence	0.9	7.2	7.4	7.5	6.6	6.3
Closing Debt[1]	498.7	495.7	492.7	489.7	486.7	483.7
Percent of GDP						
Revenue	15.0	15.0	15.0	14.9	14.6	14.4
Program Spending	12.1	11.8	11.8	11.7	11.7	11.6
Debt Service[1]	2.6	2.5	2.4	2.3	2.2	2.1
"True" Balance	0.3	0.8	0.9	0.9	0.8	0.8
Closing Debt[1]	38.0	36.1	34.2	32.3	30.6	28.9
MEMO: GDP ($t)	1.309	1.373	1.442	1.515	1.592	1.672

1. Debt repayment limited to $3 billion per year, even if the surplus is larger, to be consistent with other forecasters.
2. Fiscal forecasts for these years are on the basis of the sample macroeconomic "baseline" scenario described in Table 3.

Table 6
Detailed Revenue and Expenditure Projections
($billion)

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Revenue						
PIT	88.5	94.4	99.4	104.5	109.1	114.0
CIT	29.0	33.2	34.7	36.3	35.6	35.8
GST	29.9	31.7	33.4	35.1	36.9	38.7
EI	16.8	16.8	17.0	17.3	17.5	17.7
Customs	3.1	3.3	3.4	3.6	3.8	4.0
Energy	5.0	5.1	5.2	5.3	5.4	5.4
Other	23.9	22.1	22.9	23.8	24.7	25.6
TOTAL REV.	**196.2**	**206.6**	**216.1**	**225.7**	**232.9**	**241.3**
Program Spending						
OAS	28.0	29.1	30.5	32.1	33.5	35.0
EI	14.9	15.3	15.7	16.1	16.6	17.0
Transfers to Gov't	39.1	37.5	40.0	42.8	44.6	47.7
Other	75.7	79.0	82.7	86.2	90.3	93.7
TOTAL PGM.	**157.7**	**160.9**	**168.9**	**177.2**	**184.9**	**193.5**
Debt Service	**34.7**	**34.5**	**34.7**	**35.0**	**34.8**	**34.6**
Budget Balance	**3.9**	**11.2**	**12.4**	**13.5**	**13.1**	**13.3**

Table 7
Differences Between CCPA Projection and 2005 Budget
($billion)

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Revenue						
PIT	-1.1	0.1	-1.1	-2.6	-4.6	-6.5
CIT	0.6	4.0	5.4	6.9	8.0	8.8
GST	-0.3	0.2	0.1	0.1	0.0	0.2
EI	-0.3	-0.4	-0.6	-0.8	-1.3	-1.8
Customs	0.1	0.2	0.1	0.2	0.2	0.3
Energy	0.5	0.4	0.4	0.4	0.4	0.2
Other	0.9	1.7	1.6	1.3	1.9	2.2
TOTAL REV.	**0.4**	**6.2**	**6.0**	**5.3**	**4.5**	**3.5**
Program Spending						
OAS	0.0	0.0	0.0	0.1	0.2	0.2
EI	-0.4	-0.4	-0.6	-0.8	-1.0	-1.3
Transfers to Gov't	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL PGM.	**-0.4**	**-0.4**	**-0.6**	**-0.7**	**-0.9**	**-1.0**
Debt Service	**0.0**	**-0.6**	**-0.9**	**-1.4**	**-1.3**	**-1.6**
Budget Balance	**0.9**	**7.2**	**7.4**	**7.4**	**6.6**	**6.2**

Table 8
2004-05 Revenue Growth by Category
Comparison of Projections with 10-month *Fiscal Monitor* Data

	February 2005 Budget	CCPA Projection	10-month year-over-year actual[1]
Personal Inc. Tax	5.5	4.2	7.3
Corporate Inc. Tax	3.6	5.7	3.9
GST	6.9	5.5	11.8
Customs	4.5	8.0	3.5
Energy	-9.3	1.8	-0.4
EI Premiums	-2.5	-4.1	-2.6
Other	16.2	18.0	19.4
Total	5.2	5.4	7.1

1. *Fiscal Monitor*, January 2005 edition.

Figure 1
Evolution of Major Fiscal Ratios