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The Alternative Fiscal and Economic Update: Policy Options for the Federal Government

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Executive Summary

Under reasonable economic assumptions, the federal government will generate a final fiscal surplus of over \$6 billion in the current (1999-2000) fiscal year, and almost \$12 billion in the fiscal year covered by Paul Martin's upcoming budget (2000-2001). Over the next five budget years (fiscal 2000-01 through fiscal 2004-05), federal surpluses (in the absence of major new program or tax changes) will accumulate to a whopping \$117 billion.

This projection even allows for considerable increases in "core" federal program spending in the next two years, above officially budgeted levels, to reflect ongoing population growth, one-time expenses, and other factors. These large surpluses arise thanks to the positive impact of continued economic growth on federal tax revenues, and the ongoing decline of debt service payments as a share of GDP (the result both of a falling debt burden and lower effective interest rates).

This simulation confirms that the federal government has ample fiscal room to announce and fund major new investments in human services and public infrastructure in its coming budget, without increasing tax levels and without threatening its balanced budget position.

Current Macroeconomic Environment

Canada's macroeconomic conditions are relatively favourable at the moment. Most indications suggest that real GDP growth will equal at least 3.5% in 1999, and growth is likely to be nearly as robust again next year. Job-creation during 1999 has not been as dynamic as would have been suggested by the growth of GDP, leaving the unemployment rate stalled for some time at about 7.5%. Continued GDP growth will inevitably translate into higher employment in coming months, however, and we expect the unemployment rate to continue its gradual fall during 2000.

Interest rates remain at relatively low (nominal) levels, and are likely to remain there for some time. The Bank of Canada does not seem especially worried about inflation in Canada, and has largely abandoned its former policy of attempting to "pre-emptively" slow the economy to prevent unobserved but expected future inflation. Instead, it will follow the U.S. model of "testing the waters" on inflation: allowing for a gradual decline in unemployment until observed inflation picks up, and only then increasing interest rates.

U.S. interest rates are likely to increase in the coming months, but the Bank of Canada may not follow those moves (given the much slacker state of Canada's economy). Rising world commodity prices are strengthening the Canadian dollar in currency markets, and hence the Bank of Canada will not face as much pressure from foreign exchange markets to

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change its go-slow position on domestic interest rates.

Happy Arithmetic

The federal budget will continue to benefit from a decline in the importance of debt service charges. This results in part from the continuing decline in the debt burden: measured as a share of GDP, the net federal debt has already declined from a peak of over 70% in 1995 to an estimated 61% by the end of the current fiscal year.

The gradual filtering-through of lower interest rates into the stockpile of federal debt also helps: as older debt (some of which was initially financed in the high-interest 1980s and early 1990s) is turned over, the government benefits from the application of now lower rates.

This process was offset somewhat over the past two years by a simultaneous federal decision to increase the average term of its outstanding bonds (replacing lower-interest short-term instruments with a greater reliance on longer-term bonds), but this shift has now been completed. Hence, even if market interest rates turn up modestly in coming months (led by the expected tightening of the U.S. Federal Reserve), the average effective interest rate paid by the federal government on its outstanding debt will

continue to decline gradually in coming years. This two-fold decline in debt service charges (resulting from a shrinking debt burden and falling interest rates) is the key factor behind the improving federal fiscal balance.

Economic Assumptions

This Alternative Fiscal and Economic Update relies on the output of a simple economic simulation model, which considers the various effects of economic growth, inflation, and interest rates on the various components of the federal government's budget. For the purposes of this simulation, the following key economic assumptions are utilized (**see Table 1 for a summary**).

- Real GDP growth will equal 3.5% in 1999, 3.0% in 2000 and 2001, and 2.5% thereafter.
- Inflation equals 1.5% in 1999, and 2% thereafter.
- The effective aggregate federal tax rate falls to 17.0% of GDP in 1999 and thereafter (from 17.2% in 1998 and 17.4% in 1997), reflecting already-announced federal tax reductions.
- The effective average interest rate paid by the federal government on its outstanding stockpile of net debt falls by 10 basis points per year (from 7.2% in 1998).

	1998 (act.)	1999 (proj.)	2000	2001	Later years
Real GDP growth	2.9	3.5	3.0	3.0	2.5
GDP inflation	-0.4	1.5	2.0	2.0	2.0
Nominal GDP growth	2.5	5.0	5.0	5.0	4.5
Avg. effective interest rate, federal debt	7.2	7.1	7.0	6.9	6.8

Paul Martin's Budget Outlook

The federal government recently announced its final 1998 fiscal results. The government ran a final surplus of just under \$3 billion (approximately equal to its \$3 billion contingency fund, which is supposedly earmarked for debt repayment each year). Program spending and total tax revenues both came in about \$750 million under budget for the year.

For the purposes of our core or "base-case" economic simulation, we assume a "status-quo" government fiscal policy. We assume a constant level of federal taxation (measured as a share of GDP), with no further tax cuts (or tax increases, for that matter), and the maintenance of a "core" level of federal program spending. This core level of program spending is equivalent to the actual spending level for the previous 1998-99 fiscal year (\$111.4 billion), adjusted for population growth and inflation—so that federal program spending remains constant in real, per capita terms. [It should be noted, therefore, that this assumed level of "core" program spending already allows for a modest increase in federal spending in fiscal 1999 and 2000, above and beyond the level of spending officially envisioned in Paul Martin's 1999 budget.]

On the basis of the preceding assumptions, Martin is on tap to generate a fiscal surplus in the current fiscal year of over \$6 billion (or more than twice the official \$3 billion contingency reserve). Nomi-

nal GDP growth (including both real growth, which is strong, and inflation, which has rebounded recently from about zero to near 2%) is significantly higher than in the government's official "prudent" assumptions. This will generate additional tax revenues.

Even allowing for \$3.4 billion in additional over-budget program spending this year (which would be sufficient to maintain program spending at a constant level in real per capita terms), the government will still end the current fiscal year with a \$6.4 billion surplus. In line with recent practice, the government is likely to "use" some of that fiscal room in last-minute tax and program spending announcements, bringing its final "official" surplus back down to around the \$3 billion mark.

For fiscal 2000 (the upcoming budget year), the government has even more room. We allow for still more "core" program spending in line with inflation and population growth (bringing program spending roughly back up to its 1994 nominal level, at \$118.5 billion). The government is still poised for a surplus of almost \$12 billion.

The latent federal surplus grows with each passing year, thanks to the combined effect of increasing tax revenues (in line with economic growth) and falling debt service charges. We project the base-case simulation five years into the future, to the 2004-05 budget year. By that time, the federal surplus (again, assuming no major changes in tax policy

Table 2
Fiscal Results, Base Case Simulation

(fiscal years, \$ billions)

	1998 (act.)	1999 (proj.)	2000	2001	2002	2003	2004
Revenues	155.7	161.6	169.7	178.2	186.2	194.5	203.3
"Core" program spdng.	111.4	114.7	118.8	122.9	127.2	131.7	136.3
Debt service	41.4	40.5	39.3	37.7	35.8	33.5	30.9
Balance	+2.9	+6.4	+11.6	+17.5	+23.1	+29.3	+36.1

Source: Author's calculations from Statistics Canada and Finance Canada data.

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and the maintenance of only a "core" level of program spending) reaches \$36 billion. Over the next five years, on a cumulative basis, the combined surplus totals a whopping \$117 billion.

Implications for the Role of Government in Canada's Economy and Society

The conclusions of this simulation analysis are quite similar to those generated by other analysts (including business economists and conservative lobbyists). Without doubt, the state of federal finances has turned a fundamental corner. The continuing erosion of the federal debt burden—which will occur, we stress, even without any explicit debt repayment on the part of the federal government, purely thanks to the combination of continued economic growth and balanced budgets—opens up billions of dollars of fiscal room with each passing year.

Initially, Paul Martin and his advisors attempted to hide this happy reality through the use of unrealistically conservative economic assumptions, the \$3 billion contingency fund, and other accounting "tricks." This strategy has reached a natural limit,

however, and it is now widely recognized that the federal government needs to more transparently declare its intentions regarding the use of looming future surpluses.

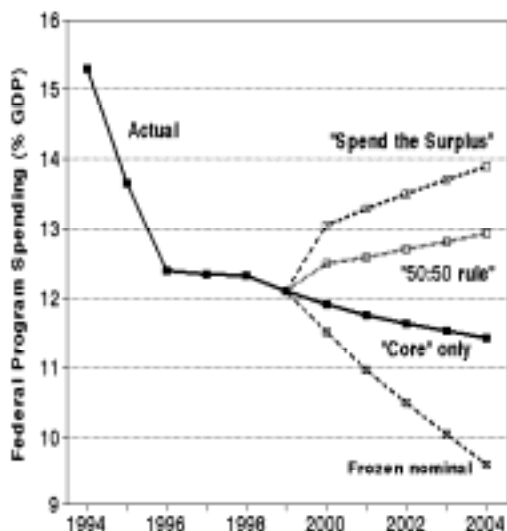
Conservatives, of course, are pushing hard for tax cuts—especially across-the-board reductions in personal income taxes, which would deliver the lion's share of future fiscal savings to the high-income Canadians who pay the most income tax. At the same time, however, there is also an emerging recognition that the continuing health of public services and infrastructure (including the state of public parks, the operational capabilities of the RCMP and the armed forces, Canada's transportation facilities, and many other public capital assets) is deteriorating rapidly under the weight of the unprecedented spending cuts of the mid-1990s.

If the federal government were to freeze tax levels, and allocate the whole of the latent surplus to reinvestment in public programs and infrastructure, it could budget for an additional \$11.6 billion in new spending in the upcoming fiscal year, and a further \$17.5 billion in the year after. [And this is on top of the normal increases in "core" program spending, of just over \$4 billion per year, that are allowed for in the "base case" simulation described above.]

Clearly, ample resources are available for the federal government to support both the repair of our existing public services and infrastructure, and the development of important new programs which seem well-suited to the changing circumstances of Canada's economy and society—such as a major initiative in universal early childhood education, which advocates suggest would cost \$2 billion per year in its initial stages, and \$5-6 billion per year once fully phased in.

Under this "spend the surplus" approach, federal program spending as a share of GDP would gradually increase from about 12% at present to some 14% after five years (see Figure 1). Note, however,

Figure 1
Federal Government Policy Options
Program spending (% of GDP), contrasting scenarios



that this would still leave a significantly smaller federal government than existed in 1994, prior to Paul Martin's historic cost-cutting budget of March, 1995 (when program spending exceeded 15% of GDP). In contrast, if the Liberal government were to allocate only one-half of its latent surplus to new program spending initiatives (as envisioned by the government's stated "50:50 rule"), then the rebuilding of federal programs occurs at an almost imperceptible pace—by less than a single percentage point of GDP after five full years.

Of course, the proposal to freeze federal program spending at current nominal levels (advocated by the Reform Party and other right-wing voices), would see a further dramatic erosion in the overall economic role of federal programs, and would clearly require another round of massive and painful retrenchment.

For the first time since he became Finance Minister, Paul Martin is expected to lay out a longer-run

(five-year) planning outlook, with at least somewhat more realistic economic assumptions, as part of his preparations for the 2000 budget. It should become crystal clear in the coming weeks, therefore, that the federal government faces a historic and fundamental choice. Will it take advantage of the ample fiscal room it will enjoy in coming years to rebuild the programs and services that were so ravaged during the 1990s? Or will it bow to the pressure of conservatives and implement tax cuts (especially income tax cuts for high-income earners) that will effectively cement federal programs in their current atrophied state?

For years government argued that fiscal circumstances forced it to implement dramatic spending cuts. This argument clearly no longer applies, if indeed it ever did. The government now has the freedom to make a fundamental choice about the direction of its programs—and, by implication, a choice about the future direction of Canadian society.