

Can We Balance the Budget: When: How?

Since Budget 2009 in January, amongst the government's most high profile promises is that they would balance the budget in 2013/14. Ever since first seeing the budget I have thought that promise was a bit optimistic, arguing that balance one year later was more realistic.

On July 6 the Parliamentary Budget Office (PBO) released a report concluding that the government would not come close to balancing the budget in 2013/14 as planned. In fact, the PBO report concluded the government should expect to have a deficit of almost \$17 billion in 2013/14. Furthermore, the PBO estimated that the government had a small structural deficit in 2013/14. The PBO concluded that "the budget is not structurally balanced over the medium term," implying that improvements in economic growth could not be counted on to generate sufficient revenue to bring budget balance over the medium term. However, the PBO did not provide forecasts beyond 2013/14. The PBO analysis implies that, for the government to meet their plan to balance the budget in 2013/14, either taxes would have to be about \$17 B. higher or spending about 17 B\$ lower or some combination there-of.

The PBO based its economic forecasts on a recent consensus of private sector forecasts, as the government does in their Budget. The PBO based their fiscal forecasts on the tax rate schedule currently planned by the government as well as spending plans as announced by the government. In fact, my view upon reading the PBO report was that, if the Finance Department did an economic and fiscal update the next day, they would come up with numbers and conclusions very similar to the PBO report.

Instead of accepting the PBO report as a reasonable update of current economic and fiscal conditions, the government has chosen to dispute, indeed discredit, the report. Finance Minister Flaherty labeled it "too pessimistic." The Finance Minister has been reported as insisting "that he remains on track to record a small surplus in the fiscal year ending in March

2014.” Both the Finance Minister and the Prime Minister have argued that Canada does not have a structural deficit. This is a significant disagreement with the PBO report.

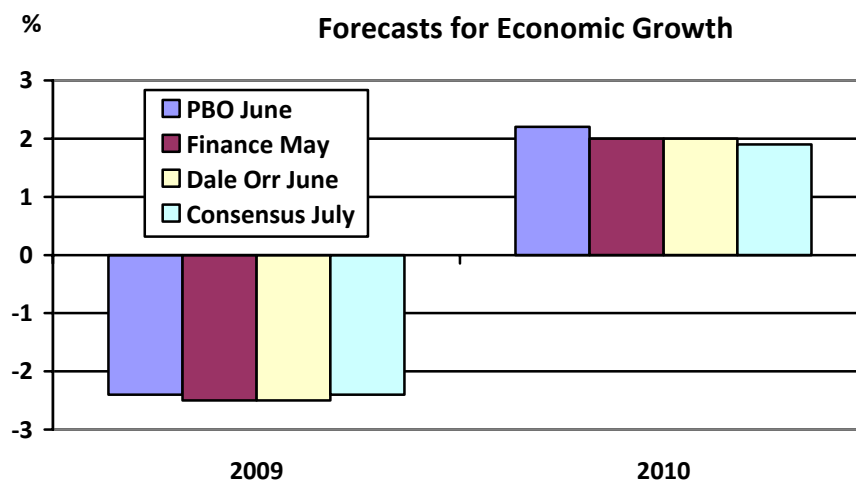
The Prime Minister has been reported as “prepared to let the deficit remain past fiscal year 2013/14 if the recovery is slow.” He emphasized that, even if the deficit persists beyond 2013/14, they will not raise taxes to balance the budget. However he did not indicate how long we may have to wait for budgetary balance if we don’t raise taxes. This is all very confusing to many Canadians.

This paper examines whether the economic forecast used by the PBO is too pessimistic. It then specifically asks whether it appears that the government will have to raise taxes and/or cut spending from current plans to meet their objective of budgetary balance in 2013/14. What tax increases of what magnitude might be necessary to bring budgetary balance in 2013/14? If the government does not raise taxes, will we ever be able to grow out of the deficit? If so, how long will that take?

Is the PBO Economic Forecast Too Pessimistic?

In my view the forecasts for economic growth (real GDP) for 2009 and 2010 used in the PBO report are very reflective of current economic thinking. The PBO uses a sample of private sector forecasts as its economic

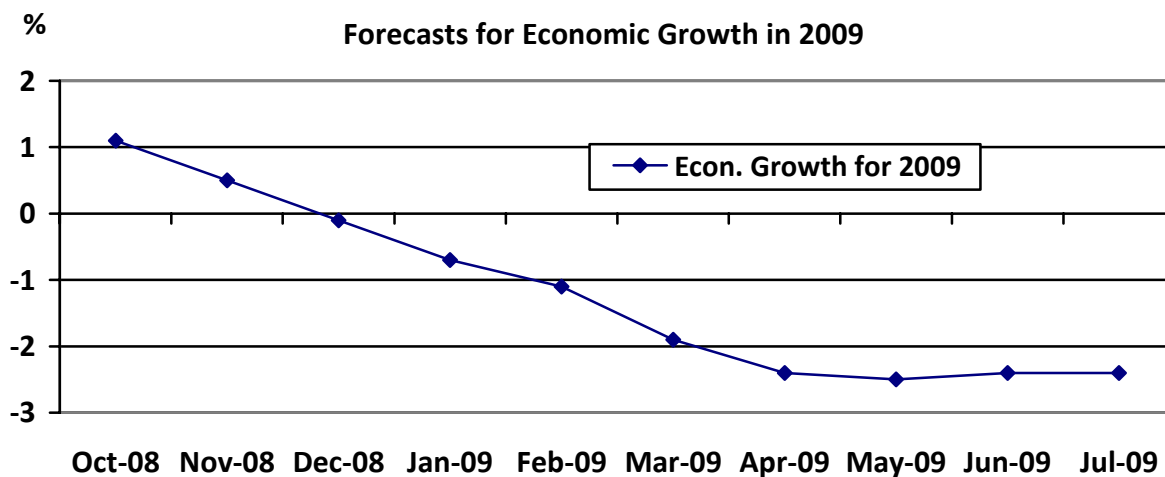
Chart 1



forecast. While the sample and timing may differ from those used by the Finance Department in federal budgets, usually differences are not significant. Recent forecasts for economic growth for 2009 are about -2.5% and for 2010 about 2.0% or a shade under these numbers. Therefore the PBO forecasts of -2.4% for 2009 and 2.2% for 2010 cannot be considered too pessimistic. If anything their forecast for 2010 may be a bit high. See chart 1.

It is important to review the rapid deterioration in the forecasts for Canada's economic growth prospects in 2009, which has occurred since the last fall. In October 2008 most economists were forecasting a very weak year for 2009, at just over 1% growth. As financial markets deteriorated economic growth forecasts fell to just barely positive in November. Indeed, the forecast used in the November 2008 Economic Update was 0.3%. Most economists started to forecast a recession for Canada for 2009 in late fall. Every month over the winter the economic indicators came in at the low end of expectations and every month the forecast for 2009 was downgraded, until April. Since April the forecast seems to have stabilized in the -2.4% range. See chart 2 below.

Chart 2

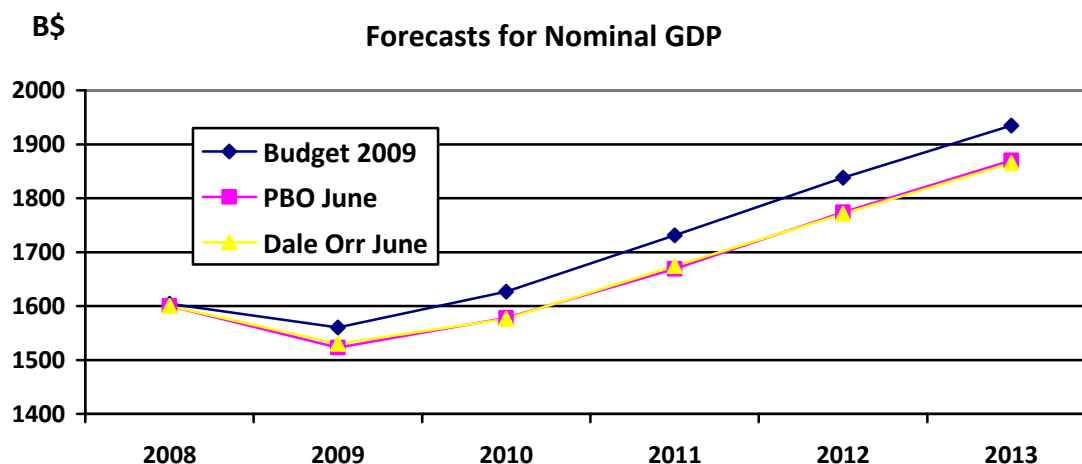


This rapid deterioration in the economic forecast has made life very difficult for finance ministers. It should be noted this is not a Canadian phenomenon. This recession is basically a "made in USA" product. In fact, last October U.S. forecasters were forecasting growth of about 0 for the U.S. for 2009.

That forecast now stands at about -2.7%. The weakness in the U.S. in this recession causes more weakness in the Canadian economy than would normally be the case since the U.S. weakness is centered on their housing, auto and financial sectors; sectors more closely integrated with their Canadian counterparts than many other sectors of the U.S. economy. Had the American forecasters forecast the U.S. economy more accurately, the forecasts for Canada would not be so much lower today than they were last October. Therefore the deteriorating economic forecast for Canada is certainly not Mr. Flaherty's fault, and to a considerable extent it is not the fault of Canadian forecasters either, it is a more U.S. phenomenon.

While economic growth (real GDP) is a major driver of government revenues, it is actually nominal GDP (real GDP plus inflation = NGDP) which forms the general tax base. Some government revenues, such as corporate income tax and GST, depend on nominal levels. Budget 2009 of January used \$1560 B. as its tax base for 2009. The government wisely used a forecast below the private sector average at that time. However, obviously, forecasts for NGDP 2009 have fallen between January and July. The July PBO report used a nominal GDP level of \$1523 B. for this year. I believe the best estimate to be just slightly higher (\$1530 B.). A June report from the TD Bank forecast \$1530 B. NGDP for 2009 and a July report from BMO was \$1526 B. The small \$7 B difference between the PBO forecast of \$1523 B. and my forecast of \$1530 B. would imply about another 1 B\$ in revenue for the government for 2009/10. This small difference would not affect any conclusions for 2009/10 reached by the PBO.

Chart 3



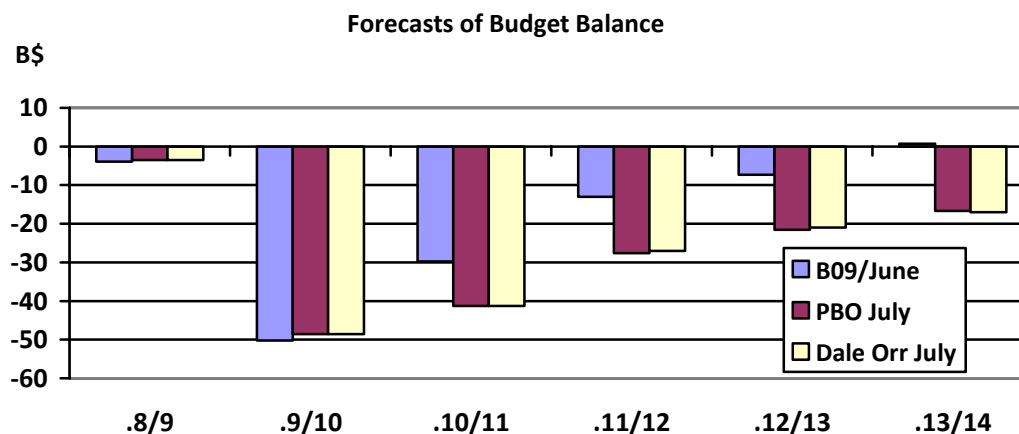
Turning to the key year of 2013/14, when the government plans to balance the budget, I note my forecast for NGDP of \$1865 is just slightly weaker than the PBO forecast of \$1870 B. In fact, my economic forecast, based on my paper “Recession and Recovery...” of late June, is so similar to that of the PBO, that it is difficult to identify differences in Chart 3.

I conclude that the economic forecast used in the July PBO report is very reflective of current economic thinking. The government is off base in criticizing it as too pessimistic. Any slight differences between the PBO economic forecast and the current consensus of private sector forecasts would not significantly affect any of the major conclusions of the PBO report. The PBO forecast for 2009 is much weaker than the economic forecast used in Budget 2009 of January, but that is primarily reflective of the downgrades to the economic growth forecast for 2009 made by most private sector forecasters between January and July.

Can the Government Balance the Budget as Planned in 2013/14?

Before focusing on the key year of 2013/14 when the government plans to balance the budget, it is important to examine the fiscal forecast for the nearer term. In its June Update the government provided an updated fiscal

Chart 4

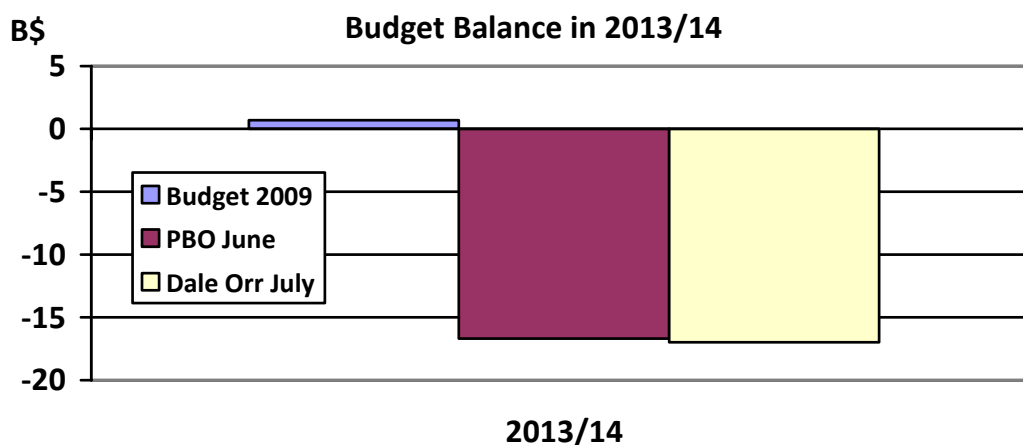


forecast for 2009/10, but not for 2010/11. Budget 2009 forecast a deficit of \$30 billion for 2010/11, but the PBO now expects that to be \$41 B. I believe the PBO's estimate to be close. See chart 4.

Turning to the critical 2013/14 year when the government plans to balance the budget, Budget 2009 forecast a tiny surplus of under \$1 B, but the PBO now expects a deficit of almost \$17 B. My analysis of Budget 2009 on budget day (January 27, 2009) led me to expect a deficit of about \$5 B. in 2013/14, with balance coming a year later. I now forecast a deficit of about \$17 billion in 2013/14, similar to the PBO estimate. See chart 4.

The deficit estimates of \$17 B., relative to the Budget 2009 estimate of a tiny surplus is mostly due to the deterioration in the economic forecast between January and July. NGDP for 2013 is now estimated to be \$1870 B. by the PBO (my forecast is \$1865) relative to the \$1935 B. used in January's Budget 2009. This is a fall of about \$70 B. between forecasts. At a revenue/NGDP ratio of 15% we could expect revenues to be about \$10 B less. The significantly weaker forecast for employment in 2013 would account for a few additional billion in lost revenue. The PBO also expects a significantly lower CIT/NGDP ratio for 2013/14 than did Budget 2009. They could be a bit pessimistic here, but their views are not unreasonable and are well documented in their report. The PBO forecasts revenues to be about \$13 B. below the Budget 2009 forecast in 2013. This lower revenue estimate therefore follows quite reasonably from the lower economic forecast.

Chart 5



Because deficits are higher over the 2010-2013 period in the PBO forecast, the PBO forecasts debt charges in 2013/14 about \$2 billion higher than does Budget 2009. Program spending for 2013/14 is forecast only slightly higher (\$2 B.) by the PBO than Budget 2009, due primarily to more EI benefits.

These assumptions and forecasts by the PBO are eminently reasonable. Most important, I conclude that the PBO estimate of a deficit of about \$17 B. for 2013/14 is reasonable. Most of the difference between this \$17 B, deficit and the surplus of \$0.7 B. of Budget 2009 is explained by the lower economic forecast. It must now be clear to the government that the tax base (NGDP) for 2013/14 is forecast to be about 70 B. lower than was forecast in Budget 2009. This loss in the tax base implies a loss of about \$10 B. in revenue. Why they continue to expect to balance the budget in 2013/14, with no new taxes or no specific plans to cut spending, leaves much to be explained.

Some government spokespersons have indicated the government plans to sell assets. Asset sales are a very questionable one time solution to a fiscal problem at the best of times. However no specific asset sales have been identified. Rumors are that sales of several billion are being contemplated. Sales of unnamed assets, in a bear market, which may or may not impact revenues in 2013/14, are not a credible challenge to the deficit forecast for 2013/14. Some government spokespersons have indicated the government may find more efficiencies in government operations. The government had 3 years in power to incorporate efficiencies into their spending plans before Budget 2009, so one can assume most have already been accounted for. Even a few billion more in 2013/14 would not affect the forecast of a significant deficit for that year.

I would argue that, if anything, a deficit of \$17 B. is an optimistic forecast. The forecast for a deficit of \$17 B. in 2013/14 incorporates three assumptions which are very optimistic regarding the financing of Employment Insurance. First, the spending forecast assumes the government will rescind the extra 5 weeks of EI benefit eligibility provided in Budget 2009, scheduled to expire in 2011. Second, the revenue forecast assumes EI premiums will be increased in 2011 and onward. Third, the spending forecast assumes that EI benefits rates will not be made more generous as a result of the review which will be underway this fall. In my view, this minority Conservative government, or any Canadian government, will find prevailing with the current assumptions regarding the financing of EI to be a serious political challenge.

I conclude that, given the current economic forecast and current tax and spending plans, it is now most reasonable to expect a deficit in the \$15 B. to

\$20 B. range in 2013/14. The government chose to argue against the report of the PBO, as opposed to accepting it as an unsurprising result of the weakening economic forecasts since the time of Budget 2009. This has led to confusion amongst many, some undeserved challenge to the credibility of the PBO, as well as a challenge to the government's own credibility.

Upon realizing that this recession would inevitably lead to the government breaking its plan to never run a deficit, the government, in Budget 2009, provided a plan to balance the budget in 2013/14. That plan to balance the budget is now no longer reasonable given current economic forecasts, tax and spending plans. The government should be clear on this point and provide an alternative plan for balancing the budget.

When Can the Government Balance the Budget? What are the Options?

We have concluded that the government cannot reasonably expect to balance the budget in 2013/14 as currently planned, given current economic forecasts and the current plans for taxes and spending. The government has three basic choices in dealing with this issue.

- First, they can accept the implications of the current economic forecasts, but hope these forecasts are too pessimistic, and hope economic growth stronger than forecast will provide the extra \$15 – 20 billion revenue by 2013/14.
- Second, they can make new plans to balance the budget in 2013/14, by raising taxes and/or reducing spending.
- Third, they can plan to “grow out of the deficit” by delaying the year of budget balance until the economy grows sufficiently to yield the required revenue.

Developing each of these basic options is a complex task, so this paper will merely provide a rough outline of these options.

(1) Hope For Economic Growth Stronger than Forecast

To balance the budget in 2013/14 as planned it now appears the government will require revenue to be about \$17 B. higher than currently forecast (\$297 B. vs. \$280 B.). As a very rough, initial approximation, this would require the tax base (NGDP) to be in the range of \$110 higher than currently forecast in 2013. This would imply a level about 6% higher (1975 vs. 1865) than currently forecast. This additional \$110 billion would be comprised of some combination of higher real economic growth and more inflation. The more it is comprised of real economic growth, particularly employment growth, the more revenues will result. GDP inflation is particularly driven up by higher commodity prices.

Recall the significant volatility in the economic forecast for 2009. (Chart 2) There continues to be volatility in the forecast for 2010. One can realistically put together an optimistic scenario which would yield a NGDP level in the \$1975 B. range for 2013 vs. the current forecast of \$1865 B. Slightly higher energy prices, a slightly stronger labor market and /or a slightly stronger recovery in the U.S. than currently forecast would be prime candidates to provide more economic growth and/or inflation over the next four years than currently forecast. Such a scenario would be considered very optimistic today, but by the time of next fall's Economic Update, it may not. In a straight judgment call, I would assign a probability of about 25% to this optimistic scenario.

(2) Make Alternate Plans Soon to Balance the Budget in 2013/14

A second basic approach to the current fiscal dilemma would be to accept the current economic forecast and make plans this year to increase taxes and/or reduce spending sufficient to generate the extra net revenue to balance the budget in 2013/14. Prime Minister Harper has said that "we will not start raising taxes and cutting programs. That's a very dumb policy." Nevertheless, it is not clear Mr. Harper understands just how long he may have to wait to balance the budget if he doesn't increase taxes. As well, there is always the possibility of a change in government. Therefore, notwithstanding the Prime Minister's current distaste for this option, it is worthwhile to identify its basic ingredients.

First, I rule out consideration of spending reductions. Recall the pressures on EI funding and the increased pressures from the aging population. The

current plan has spending actually lower in 2011/12 than in the previous year and growing at an average pace of only about 4% over the final years of the plan to 2013/14. In the pre-recession years of this administration, program spending increased at an average pace of about 6%, not to mention the 17% this year. Therefore, it is simply not realistic to expect this government, or any other government, to hold program spending to less than about 4% growth over the post recession period. Therefore, if the current economic forecast prevails, raising taxes is the only realistic option to balance the budget by 2013/14.

To balance the budget in 2013/14 tax increases would have to provide about \$17 B. more revenue. This would imply an increase in revenue of about 6%. That is, in this scenario we are getting the extra 6% (or \$17 B.) in revenue through a tax increase as opposed to extra economic growth as considered previously in Option 1.

For illustrative purposes, consider two basic tax increases. First, the government could “temporarily” re-impose the 2% point GST reduction. This would yield about \$13 B. of the required \$17 B. for 2013/14. The other \$4 B. might be raised by a “temporary” surcharge on Personal Income Taxes (PIT). We will be collecting about \$145 B. PIT in 2013/14, so this would be an increase in PIT of about 3%. Alternatively, if all of the required \$17 B. were raised by a “temporary” increase in PIT, that would require an increase of about 12% in PIT ($17/145=.12$). Since the base case scenario has the deficit decreasing by several billion each year, the tax increases could be phased down to zero over the 2013/14 – 2019/20 period.

The above analysis answers a question often raised. That is, would the government still be in danger of missing their budget balance target in 2013/14 if they had not cut the GST? It appears the deficit would be forecast at about \$4 B. for 2013/14 instead of \$17 B., if the GST had remained at 7% instead of 5%. The GST reductions have therefore been major contributors to the deficit now forecast for 2013/14, but the deficit problem goes beyond the GST reductions.

(3) Plan to “Grow Out” of the Deficit Hole

The Prime Minister has expressed his clear preference for “growing out” of the deficit hole, as opposed to filling it in with tax increases. The PBO report expressed serious reservations, given current tax and spending plans, for

economic growth to provide sufficient revenues to eliminate the \$17 B. deficit of 2013/14, over the medium term. The government clearly continues to believe that “growing out” is a viable option. However, they have not indicated how long it may take for economic growth to eliminate the deficit.

Very roughly, growing out of a deficit is a viable option as long as program spending is growing at less than the pace of the tax base (NGDP) and interest rates are stable. With a progressive Personal Income Tax, PIT revenues will increase at a higher pace than the general tax base and other revenues will grow at roughly the same pace. Overall, given a set of many but reasonable assumptions, including the key assumptions above, revenues will grow more than spending, (in both % and \$ terms), permitting the government to eventually “grow out” of a deficit.

There are three serious problems with the “growing out” option. The first has been well known for many years. After 2011, when the baby boomers begin to leave full time employment, the potential growth rate of the economy begins to fall from the 2.7% of the past decade, to the 2.4% range over the 2014- 2010 period. To make fiscal matters worse, these same aging baby boomers will qualify for government pensions and require more health care. This implies that it will become increasingly difficult for the government to keep the annual increase in program spending below 4%.

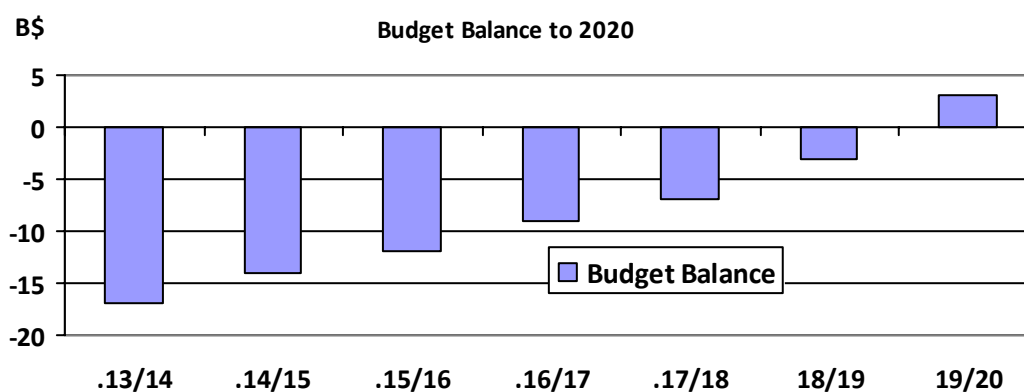
The second problem is that, while waiting for economic growth to generate the revenues required, we would be particularly vulnerable to a spike in interest rates. Of course, interest rates spikes are much more likely when economic growth is strong. With a debt in the \$650 B. range and debt charges in the \$40 billion range, debt charges could easily be driven several billion dollars higher by a spike in interest rates, frustrating and delaying efforts to balance the budget. This is very much what happened in the early 1980's and again in the late 1980's.

The third problem with the “growing out” option has arisen as a result of the significant losses of revenue and the spending increases during this recession. The high deficits incurred during the recession, peaking at \$50 B. in 2009/10 and declining to \$17 B. by 2013/14, will result in a level of debt of \$616 B. by 2013/14. This presents two problems within the “growing out” option.

First, we are starting from a level of debt in 2013/14 of \$17 B. instead of the small surplus forecast in Budget 2009. That is, there is a much bigger hole to “grow out” of. Second, there is \$74 B. more debt than forecast in Budget 2009, resulting in debt charges of several billion more in 2013/14 relative to what was forecast in Budget 2009. The forecast for lower interest rates reduces this problem somewhat. However, on net going forward, some of the extra revenues generated by economic growth must be used to cover higher debt charges, they cannot all be allocated to increased deficit reduction.

The following scenario assumes economic growth averaging 2.4% over the 2014 – 2020 period, with inflation at 2%. Therefore NGDP is growing at 4.4%. Revenues grow at a slightly higher rate than NGDP due to the progressivity of the PIT. Program expenses are assumed to grow at 4% per year. Recall that program spending at a 4% pace over this period must be considered “restrained,” considering the pressures from demographics noted above. Even though interest rates are considered stable over this period, debt charges are growing slightly since the level of debt is still growing due to the continued deficits. Interest rates are assumed to be stable. I consider this to be a reasonable “base case” scenario, however, more optimistic and more pessimistic scenarios could reasonably be generated.

Chart 6



In this scenario the government can “grow out” of the deficit, but it takes a long time. The deficit falls from the \$17 B. of 2013/14 to balance in 2019/20. Therefore, in my view, we do not have a “structural deficit.” However it now appears it will take until 2019 to balance the budget without any tax increases, even with a restrained spending profile.

This scenario drives home the importance of not adding any more to the level of ongoing program spending obligations. This advice is particularly directed to the panel addressing EI reform. Even with very restrained spending plans, it now appears it will take until 2019 to “grow out of” the current deficit hole. For example, if program spending were to grow at the same rate as NGDP (4.4% annually instead of 4%) , it would take about three additional years (ie. until 2022) to balance the budget.

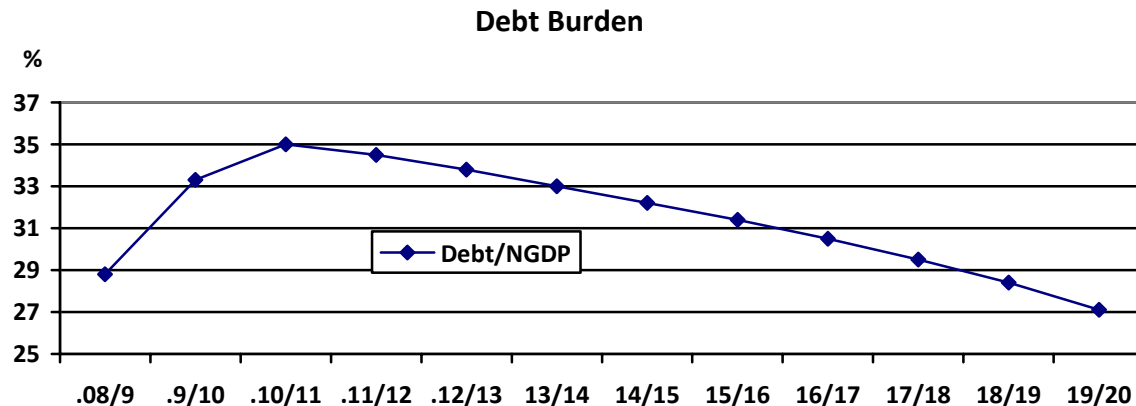
Which Option to Choose?

Which option the government should chose to deal with the current fiscal dilemma is probably the subject of debate between and within political parties “as we speak.” Of course, the first option, hoping for an upturn in economic forecasts, does not preclude later moving to the second or third option.

We could not blame the government if they implicitly chose the first option and waited until the Economic and Fiscal Update expected in this fall before announcing any other fiscal plan. There is a reasonable probability a stronger economic forecast at that time will make the problem easier to manage. I do not believe there is a political appetite for the second option, nor does Mr. Harper. If the economic forecast does not improve significantly by the fall, then it appears the government would then have to be very explicit in their choice of options. They appear to be favoring option (3) (growing out).

To support the third option, “growing out,” we should note that the debt burden (debt/NGDP) will only rise from 28.8% in 2008/09, its lowest level since 1980, to a peak of 35% in 2010/11, and then down to 27.1% by 2019/20. See chart 7. Even though we have deficits over the 2011 – 2020 period they are sufficiently small that the pace of growth in the debt is less than the pace of growth of the economy, yielding a declining debt burden. That is, we have deficits and growing debt but our ability to pay for it is growing faster than the debt. Even under this growing out option, Canada will probably continue to have a modest debt burden relative to most other developed countries, especially the U.S.

Chart 7



Policy Recommendations

The time has come for the government to publicly recognize that current economic forecasts make their Budget 2009 plan to balance the budget in 2013/14 unrealistic. They have prided themselves in having a plan for bringing the country back to fiscal health after the recession. Their plan of Budget 2009 is no longer on track. The government needs to quickly develop a new plan for restoring our fiscal health. They appear to favor “growing out” of the deficits over time, as opposed to increasing taxes to accelerate deficit elimination. If this is their preferred option then they must ensure they have the Canadian public, as well as their political opposition, on board to accept deficits for the next decade.