

The Path to Deficit Elimination: “Growing Out” is Too Risky

One of the most important economic policy challenges facing the government is to identify how they plan to eliminate the fiscal deficit, which will rise to over \$50 billion this year. It is important to eliminate the deficit since deficits limit the ability of the Finance Minister to serve new tax and spending priorities. Perhaps even more important, how the government plans to manage tax and spending policy to eliminate the deficit reveals their fundamental values regarding both economic and social policy.

In July the Prime Minister indicated that the government would not increase taxes or cut spending to eliminate the deficit, instead they would rely basically on economic growth over time to provide the necessary revenues to eliminate the deficit. This is what we mean by the “growing out” option. My September “Economic and Fiscal Update” concluded that the “growing out” option was certainly possible. However, under reasonable economic and fiscal forecasts, under the growing out option, with no significant tax increases or spending cuts to accelerate deficit elimination, we could not expect the deficit to be eliminated before 2018. Furthermore, the growing out option is risky since, while we are waiting those many years for economic growth eliminate the deficit, a spike in interest rates and/or a dip in economic growth can set our deficit reduction plans off track.

On September 10 the government released its “Update of Economic and Fiscal Projections” (Update). As expected, they presented plans for the “growing out” option, giving high profile to their claim that they were not going to rely on tax increases and they planned to protect the growth track of major transfers to persons as well as to other levels of government. This Update presented a fiscal plan to reduce the deficit from \$56 billion this year to about \$5 billion in 2014/15. They did not extend the fiscal forecast to actually show a date of deficit elimination, but did note their commitment to return to a balanced budget in due course.

The Update and Projection and Scene 1, the Spending Assumption

Chart 1 shows an “Update and Projection.” The forecast deficit through 2014/15 is directly from the Update Table 1. The projection, projects revenue growth forward at the same pace as it grew in 2014/15. Program Spending is assumed to continue to grow at the same 3% pace per year as forecast in 2014/15.

My September paper showed a deficit of \$9 billion in 2014/15. Under the government’s growing out option the deficit was \$5.2 billion in 2014/15. This difference is entirely due to the assumption in the Update that the government would hold program spending growth to only about 3% per year in 2013/14 and 2014/15. Under my assumption of 4% spending growth per year over this period, program spending would be \$266 billion in 2014/15. In the Update program spending is only \$261.4 billion in 2014/15. This difference of \$4.6 in spending accounts for the \$4 billion difference in the level of the deficits forecast in 2014/15.

In my Commentary (September 2009) on the government’s Update I repeated my argument that, given the demographic pressures from baby boomer retirements beginning about 2011, the government’s miserable record in containing pressures for spending, as well as noting that all the political opposition to this minority government is on the left, I think it is unwise and unrealistic for the government to assume they can limit program spending to less than about 4% growth over this period. It may well be possible for a majority Conservative government, in 2014, to limit program spending to 3% growth in 2014. However, I do not think it realistic to expect a minority Conservative government in 2009, to survive, with a medium term fiscal plan which depends upon program spending restraint this tight.

Scene 1 in Chart 1 simply employs the same revenue assumption as the Update and Projection, but assumes program spending growth after 2011/12 at 4% rather than 3% as in the “Update and Projection.” I believe this to be a more realistic fiscal plan.

Chart 1 reveals that if program spending were to grow at 4% as opposed to only 3% per year, the fiscal deficit would be \$9.9 billion in 2014/15 rather than \$5.2 billion. Under the 4% program spending assumption the deficit is not eliminated until 2018/19, as opposed to 2015/16, projecting from the Update and its 3% program spending growth assumption. Obviously, if

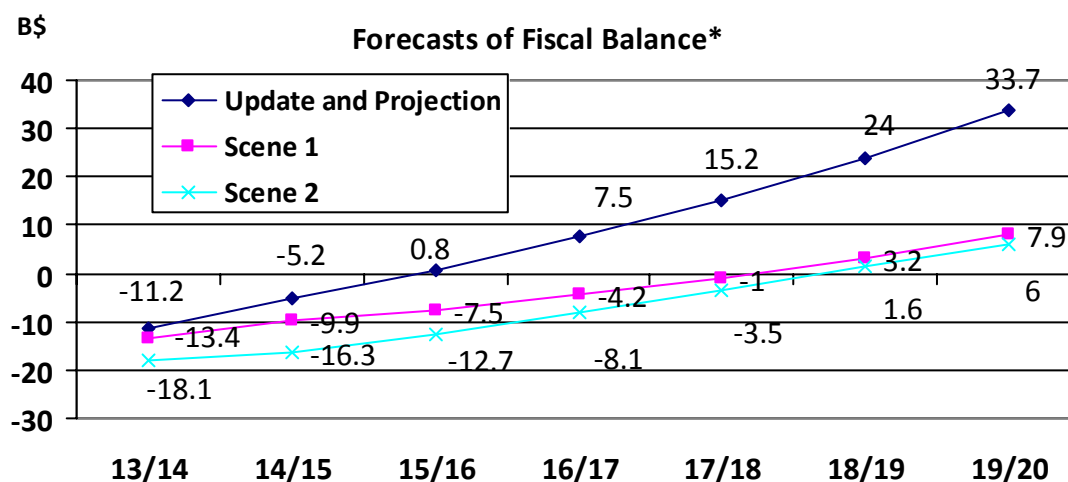
program spending can be restrained to 3% growth rather than 4% growth, this pays significant dividends in the efforts to eliminate the deficit. However, I do not think this magnitude of restraint is realistic as a current planning assumption. Indeed, considering the pressures the government spending will be under over this period, it may not be a wise policy.

Scene 2 the EI Premium Increase Assumption

My October paper “How Increases in EI Premiums Speed Up Deficit Elimination,” estimated the impact of planned increases in EI premiums on EI revenues and the fiscal deficit over the 2011-2014 period. While I support the concept of balancing EI “over time” I do not believe EI rates should be hiked over the 2011-2014 period to cover the deficit in EI incurred in 2009 and 2010.

An increase in EI premiums, from the employees’ perspective, is a tax on working. From the employer’s perspective, EI premiums are a tax on hiring. Over the longer term, higher EI premiums lead to a level of employment lower than otherwise. An increase in EI premiums is not only one of the most economically harmful taxes, it is also one of the most perverse. It affects lower income workers relatively more heavily than higher paid workers since EI premiums are not collected on earnings over a threshold.

Chart 1



In my earlier paper I estimated the increase in EI revenues resulting from raising EI premium rates above their current level to be \$1.5 billion in 2011/12, increasing to over \$6 billion in 2014/15, to eliminate the cumulative deficit in EI of about \$13 billion which arose over the 2009 – 2010 period.

If, instead of increasing EI premiums above their current levels, EI premium rates were held at the current \$1.73 level, EI revenues and the fiscal deficit would be lower than otherwise over the 2011/12 – 2014/15 period. Scene 2 shows the estimated fiscal deficits if program spending were to grow at the 4% pace of the Scene 1 profile and if EI rates were also held at current levels as opposed to increasing as assumed in the Update. If each of these changes from the Update were to apply then the fiscal deficit for Scene 2 would be -\$16.3 in 2014/15, rather than the -\$9.9 of Scene 1 or the -\$5.2 of the Update. Note that the Scene 1 and Scene 2 deficits are larger, therefore slightly higher debt charges also result. Under the assumptions of Scene 2, the deficit is not eliminated until 2018/19.

Scene 2 With Temporary GST Increase

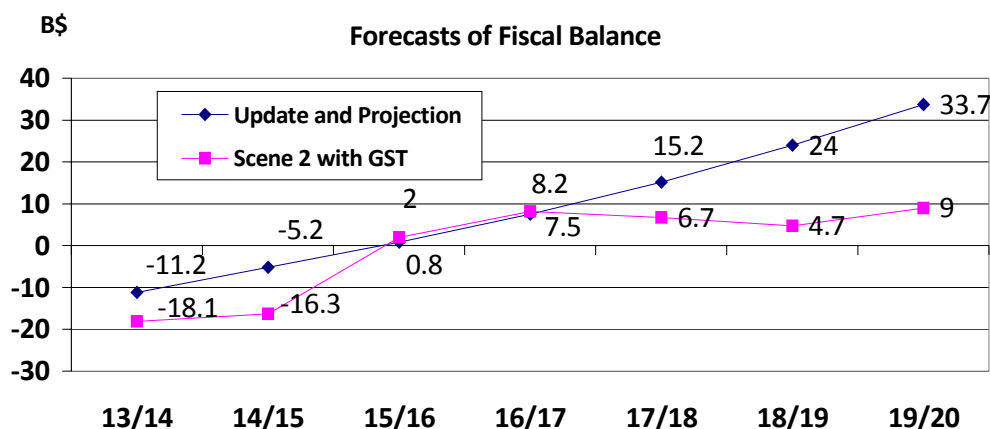
If the government wishes to accelerate deficit elimination by increasing taxes – as they are with the increase in EI premium rates above current levels in their Update and as reported in Scene 2, then I argue that they should temporarily increase the GST as opposed to increasing EI premium rates. From the Update it is obvious that the government does not plan to eliminate the deficit before 2014/15. They show a deficit of about \$5 billion for that year. They do not extend their fiscal plan beyond 2014/15 to show a date for deficit elimination. However, extending their fiscal plan under similar assumptions results in deficit elimination in 2015/16. As shown above, moving program spending up to a 4% per year growth pace (Scene 1) and then also eliminating the planned increases in EI premiums (Scene 2) would move deficit elimination to 2018/19.

In Scene 2 the deficit in 2015/16 is \$-12.7 billion. By 2015/16 each 1% point increase in GST will bring in a bit over \$7 billion. Therefore, if in 2015, the GST is increased by 2% points, to 7% instead of the current 5%, about \$14 billion in additional revenue would result. Therefore, with the temporary 2% point increase in the GST, there would be a small surplus in 2015/16, instead of a deficit. That is, the government could increase

spending at 4% per year as well as keep EI premiums at the current level and eliminate the deficit as soon as they planned to in 2015/16, if they were to impose a temporary increase in the GST.

To keep the budget balanced, the 2% increase in the GST would have to be kept in place over 2016/17. However, in 2017/18 it could be cut down to a 1% increase, leaving the GST at 6% instead of 7% and the budget would still show a small surplus. The GST could be cut back to the original 5% level the next year, 2018/19, still leaving the government in surplus. That is, the extent of the temporary GST increase would be an increase of 2% points for about 2 years with an increase of 1% point for an additional year. The incremental revenues from this temporary tax would cover the extra program spending as well as the loss in EI revenues.

Chart 2



What Can We Expect to Happen?

At this point in time there is strong momentum towards the fiscal plan of the government's Update. The problem with that plan is that it is unrealistic, it is not effective economic policy and I argue it is not equitable either.

First, we can expect the government to attempt to stick to its plan to restrict program spending to 3% growth. But, I argue, they will probably fail to actually restrict spending to that level when the time comes, and that is probably a good thing.

Second, they will probably continue to plan for increases in EI premiums. They can be expected to be successful in implementing those increases, but that is not effective economic policy and it is unfair to workers and employers. The Liberal opposition has not seriously challenged the Conservatives plans to increase EI premiums. After all, it was the Liberals who profited mightily from huge surpluses in EI over the 1995- 2005 period. Some might expect the NDP to stand up for workers, especially the lower paid workers who disproportionately pay EI premiums. However, the NDP has shown much more interest in keeping EI premiums high. A surplus in EI strengthens their ability to argue for increased EI benefits.

Third, we cannot expect the government to take my advice and raise revenues through a temporary GST tax as opposed to increasing EI premiums. As noted above, I do not expect the increase in EI premiums to face serious political opposition. I, along with other economists, have argued for temporary increases in GST, as opposed to raising revenue from other sources, before. We have certainly argued strongly against reducing the GST as opposed to reductions in Personal Income Tax or Corporate Income Tax. The recent public opposition to the imposition of the GST tax base as part of the harmonization of GST and provincial sales taxes in Ontario and B.C. will not warm the federal government to an increase in GST rates.

Putting the above expectations together, we can expect the government to continue to support the fiscal plan of their Update. However, when we arrive at 2014, it is more likely program spending will actually run at closer to a 4% pace than a 3% pace. I assume the EI premiums will have been increased and the EI account has been balanced over the 2009- 2014 period. I expect that, by 2014 or very shortly thereafter, the date of deficit elimination will be moved out to 2018, primarily due to the slippage in spending commitments.

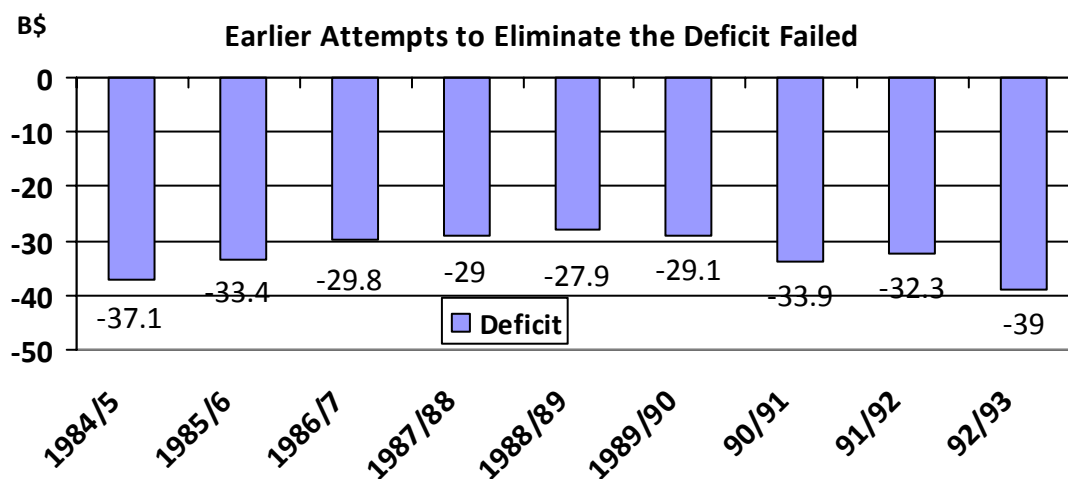
Waiting for Four Years For Deficit Elimination is Risky

Before the end of 2014/15 therefore, I expect that we the government will already have missed their spending restraint plan and will have revised the plan to a more realistic pace going forward. If 4% program spending growth were substituted for the current 3% spending plan, deficit elimination would occur about 2018 instead of about 2015. This is a reasonable fiscal forecast as long as the economic forecast stays close to the current track. The current economic forecast could, of course, turn out to be too optimistic or too

pessimistic. However, there is a chance that, over the 2014 – 2018 period, an unexpected spike in interest rates could drive up debt charges sufficiently to push the expected date of deficit elimination out by a year. There is also a reasonable chance that a dip in economic growth could move revenue collections down sufficiently to delay the forecast date of deficit elimination by a year. There is also a reasonable chance that strong pressures for “a one-time urgent” increase in spending will arise (anyone have a feeling of déjà vu all over again?) . It could be defense spending, it could be an unanticipated health care need arising from the sharp change in demographics, it could be a need for regional development, or another industrial rescue.

The probability of getting through 4 years without one or more of these claims on the public purse to set back the deficit elimination track, is small. Of course, there is also a good chance that some offsetting unanticipated good news will come by. On net however, there is a probability, which I judgmentally place at about 30%, that one of these risks will derail the deficit elimination track at some point over the 4 year (2014 – 2018) period.

Chart 3



As revealed in Chart 3 above, the government’s attempts to balance the budget over the 1984 through 1993 period were a failure. Just as deficit reduction was picking up steam, in 1989/90 it was knocked off track by a spike in interest rates, which drove debt charges up sharply. After several years of relative stability it was knocked off track again in 1992/93 by a downturn in the economy, which caused a significant unanticipated

reduction in revenues. The 1993 – 1997 deficit elimination plan was successful, largely because it relied heavily upon spending cuts to other levels of government. This approach has been “taken off the table” in the deficit reduction plan of the government’s September 2009 Update.

Therefore, under the current economic forecast and reasonable fiscal assumptions, we cannot expect deficit elimination before 2018. And, there is a reasonable probability that, in 2014, if we accept a fiscal plan to eliminate the deficit by 2018, that plan will be derailed by known economic and /or fiscal risks. I therefore recommend that we pre-empt the unrealistic assumptions and the risks and incorporate into the fiscal plan , a temporary 2% point increase in the GST in 2015/16, which would eliminate the deficit in that year.