

## **Economic and Fiscal Update**

Following the release of the Q2 National Accounts on August 31, economists are updating their economic forecasts. These updates are particularly important to Canada's economic and fiscal future. It finally appears we are pulling out of one of the worst recessions of our lifetimes. What will be the pace and strength of the recovery? What are the key risks to recovery? On the fiscal side, does the updated economic forecast indicate the government can meet its Budget 2009 plans? If not, what are their options? The government will soon have to face these questions in their Fall 2009 Economic and Fiscal Update or before. It being a minority government, it is distinctly possible that the option the government chooses to deal with these fiscal issues could precipitate an election as well as determine the election outcome.

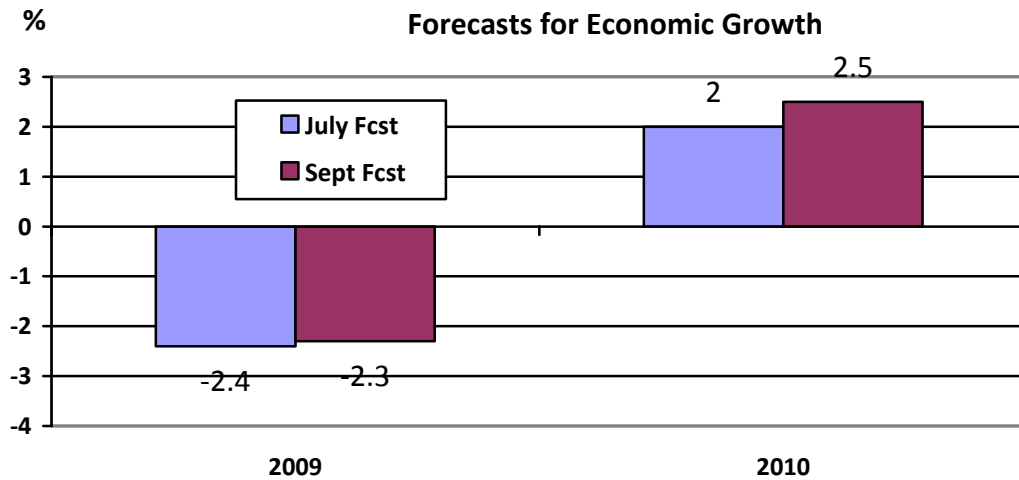
This paper follows my July paper "Can We Balance the Budget: When and How?" That paper concluded that, based on the economic forecasts of July, the government could expect a deficit of about \$17 billion in 2013/14, as opposed to the small surplus they planned for in Budget 2009. If they chose to "grow out" of this deficit hole, as opposed to raising taxes sufficiently to hit the 2013/14 deficit elimination target, then we would not balance the budget until about 2019/20. This paper specifically revisits these issues and examines the fiscal policy options facing the government in more detail.

### **The Economic Update**

The Q2 National Accounts reported -3.4% growth for the second quarter, slightly weaker than expected. To add to this weakness, Q1 was revised down from -5.4% to -6.1%. The domestic economy performed reasonably well in the second quarter. Auto sales, the housing sector and consumer spending generally were a source of strength. The weakness was found in exports and business investment. The trend within the second quarter gave

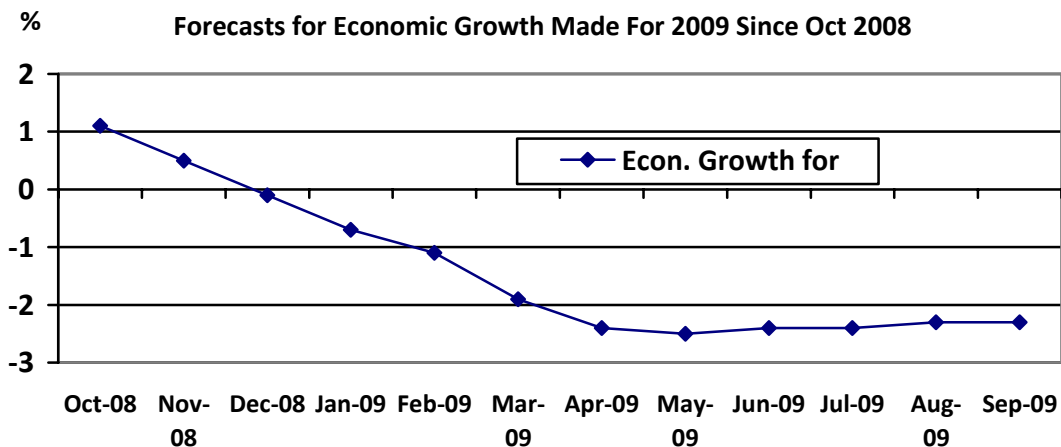
signs of hope, as June was the strongest month, and first month of positive economic growth since last August. Recent economic data, beyond the National Accounts also gives hope, particularly a bit better outlook for the U.S. and Europe for the next year.

Chart 1.



Taking account of all of the new information since July, I now expect the Canadian economy to grow -2.3% in 2009, as opposed to the -2.4% forecast in July. See chart 1. It is very important to note that, after falling sharply and consistently from last September until April, the forecasts for growth for this year seem to now have stabilized in the -2.3% range. See chart 2.

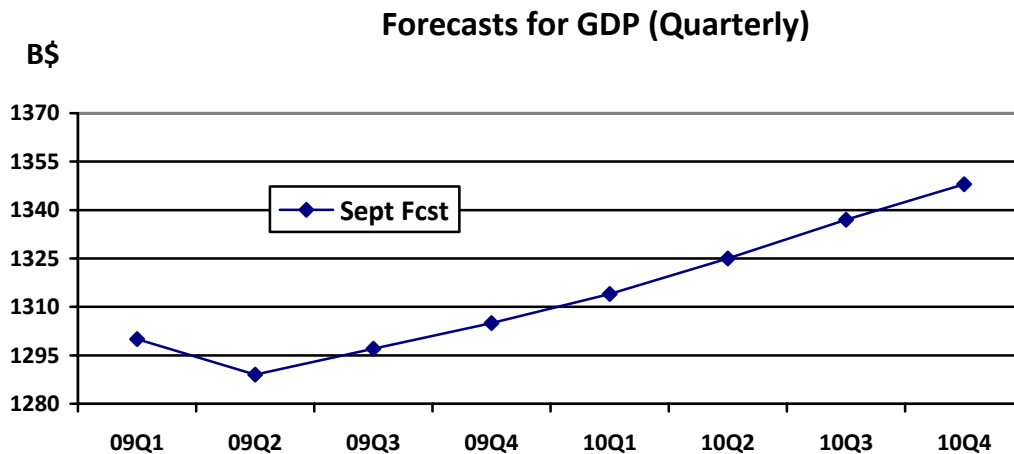
Chart 2



Forecasts for next year range from the optimistic 3% of the Bank of Canada, down to the pessimistic 0.7% of the OECD. I expect 2.5% growth next year, and I expect that will be representative of leading private sector forecasters as they come out with their revised forecasts over the next month.

There is considerable interest in the quarterly pattern of growth. See chart 3. The first quarter, at -6.1%, was the weakest quarter on record, but most economists are now expecting 2009 Q3 to be the first quarter of positive growth since 2008 Q3. The economy won't have reached its previous peak level of 2008 Q3 until 2010 Q2. The economy will be weaker over the first half of this year than forecast in July. However, by the end of 2009 the level of real output will be just slightly stronger than forecast in July. By the end of 2010 it will be just over the 2008 level, as opposed to just under, as forecast in July.

Chart 3

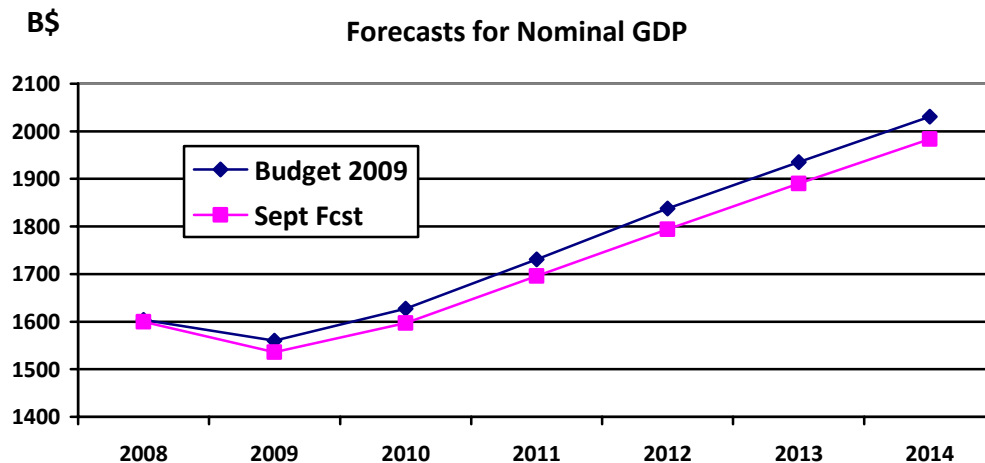


While real GDP is the best over-all indicator of the economy's performance, it is Nominal GDP, that is economic growth before inflation as opposed to after taking out the impacts of inflation, that is the general tax base. Some of the taxes of the federal government, particularly corporate tax and GST, depend on before inflation prices as opposed to after inflation prices. The rate of Nominal GDP growth is simply the rate of real GDP growth plus the rate of GDP inflation.

The levels of Nominal GDP (NGDP) forecast in September are slightly higher than the levels forecast in July. By the end of 2010 NGDP is just over 1% greater than the July forecast, a gap maintained right through 2013.

It is very important to compare the level of NGDP, the general tax base, forecast today, relative to the forecast in January's Budget 2009. Today, NGDP is forecast to be about \$24 billion lower for 2009, about \$30 billion lower for 2010 and about \$45 billion lower for the key year of 2013/14. This is, of course, the major reason fiscal deficits are now forecast to be greater in each of these years than what was forecast in January's Budget 2009.

Chart 4

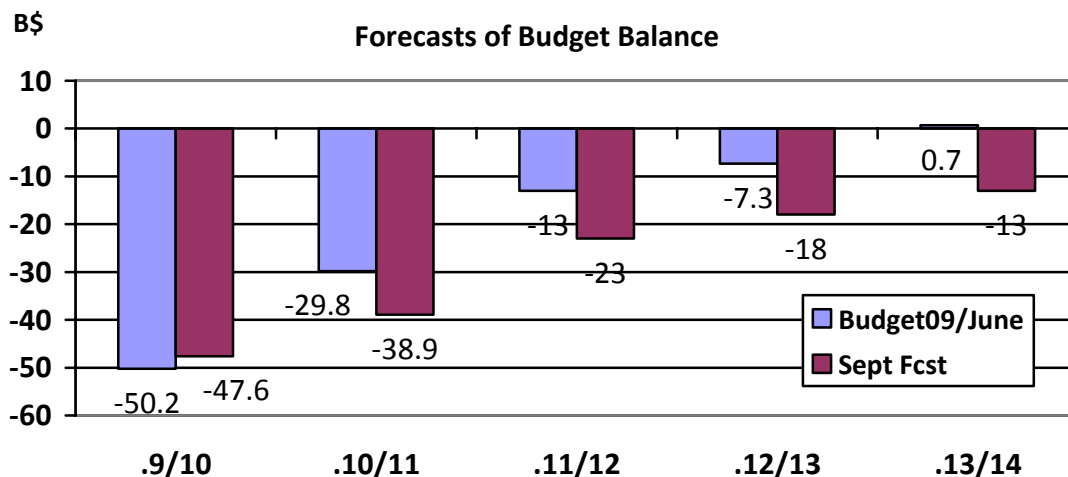


It is important to emphasize that the lower forecasts of NGDP for 2009 right through 2013/14 cannot be blamed on Mr. Flaherty. Since January, both real GDP and NGDP for 2008 have been revised down. The Canadian economy will experience significantly less real growth this year (-2.3%) than forecast in Budget 2009 (-0.8%). To be prudent, Budget 2009 even used a NGDP forecast below the private sector consensus at the time. The main reason that private sector forecast was too high is that the forecast for real GDP in the U.S. was too optimistic. Had the Fed forecast the recession of 2009 in the U.S. more accurately, Canadian forecasters in Canada would have provided much more accurate economic forecasts for Budget 2009.

## Fiscal Forecasts

In their June “Action Plan...” the government updated the forecast for the 2009/10 deficit to -\$50.2 billion. This forecast still seems on target, (if not slightly pessimistic) with my updated forecast of -\$47.6 billion. In their June 2009 Action Plan...” the government did not provide an update of their forecast for the 2010/11 deficit. This is an announcement that is becoming a bit overdue. It may appear in their September Action Plan, or if not in their fall Economic and Fiscal Update. Following my updated September economic forecast and other factors impacting revenues, and taking account of recent spending commitments, particularly the subsidy to B.C. for HST harmonization in 2010, I now forecast the 2010/11 deficit to be about -\$39 billion, relative to the -\$30 billion forecast in Budget 2009. For the key year of 2013/14 when Budget 2009 forecast a small surplus (of \$0.7 billion), I now forecast a deficit of -\$13 billion. See chart 5

Chart 5



Note the Budget09/June forecast is the B09 forecast as updated for 2009/10 in June

The differences in forecasts of the deficit can be traced primarily to the impacts of the lower tax base (NGDP) forecast in September relative to the January 2009 Budget forecast, on revenues. Differences in the forecast of spending and debt charges are minor. For example, the \$13.7 billion difference in forecast of the Budgetary Balance for 2013/14 is comprised of \$10 billion less revenue, \$2 billion more spending and \$1 billion higher debt charges. \$7 billion of the \$10 billion lower revenue can be traced directly to the \$45 billion lower forecast of NGDP, the remainder to assumptions

regarding the impact of the recession and recovery on the growth of Personal Income Tax and corporate income tax.

### **Fiscal Policy Options**

In their Fall Economic and Fiscal Update, if not before, unless the economic forecast has picked up remarkably from this September forecast, the government is faced with several tough issues.

**First**, they will have to recognize that the deficit for 2010/11 will be in the \$38 billion range as opposed to the \$30 billion range forecasted in Budget 2009.

**Second**, and far more important, they will have to recognize that the economic forecast has weakened so much since January's Budget 2009 that they cannot plan on eliminating the deficit in 2013/14 with the Budget 2009 spending plan.

**Third**, they will have to present a new plan for eliminating the deficit.

In terms of new plans for eliminating the deficit, there are two basic approaches. First, the government could simply announce that they will not alter the Budget 2009 spending plan significantly, depending upon economic growth to generate sufficient revenues to eventually eliminate the deficit. This "**growing out**" option is viable as long as the government does not have a "structural deficit," as long as no dips in economic growth occur over the period and/or there are no spikes in interest rates. The key condition regarding the "structural deficit" is that the annual pace of program spending growth must be less than the annual pace of revenue growth (a necessary but not sufficient condition). A reasonable assumption over the 2014 – 2020 period, the assumption I have made, is that program spending growth will be 4% annually and that the annual rate of NGDP growth of 4.4% ( 2.4% RGDP growth and 2% inflation) will generate revenue growth of 4.84%. These revenue and spending assumptions recognize the changing demographics of the 2013 – 2020 period.

Given the demands on the government over the 2013 – 2020 period, it is unrealistic to think they will be able to keep annual program spending growth below 4% over this period. It is even more unrealistic to expect this

minority government could survive the heat from the opposition parties if they proposed, in 2009, to reduce the forecast deficit by reducing program spending growth below a 4% annual pace. Therefore, I do not consider anything but minor spending reductions to be an option for deficit reduction over the 2013 – 2020 period. Therefore, if the government does not select the growing out option, the other basic approach would be to **temporarily increase taxes** sufficiently to eliminate the deficit in 2013/14 and to maintain a balanced budget after that.

### The “Growing Out” Option

The September economic forecast yields a forecast deficit of \$13 billion in 2013/14. Key revenue assumptions going forward after 2014 are:

- PIT accounts for about 50% of the total revenue
- A 1% increase in NGDP and Personal Income will generate about 1.2% in incremental PIT revenue (NGDP growth=4.4%, revenue growth = 4.84%)
- The other sources of revenue will grow at about the same pace as the tax base

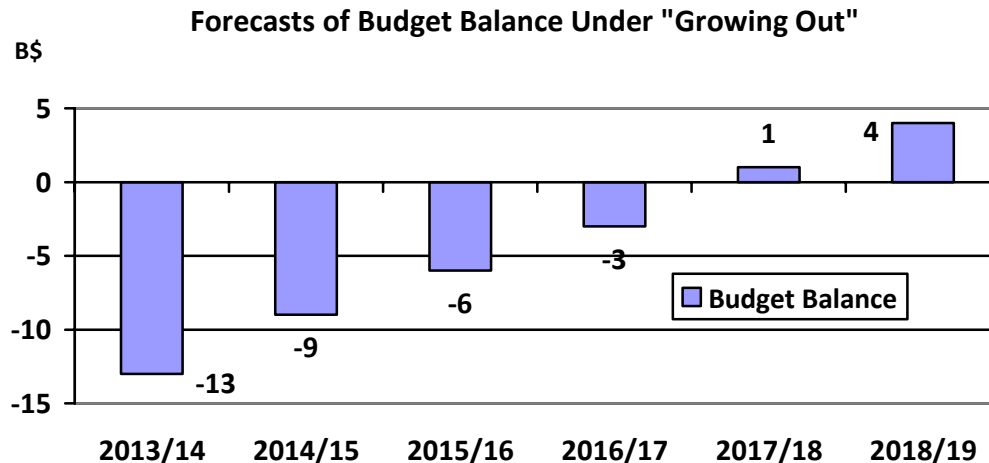
As noted above, the critical program spending assumption is that program spending grows at an annual pace of 4%. We assume after 2014, debt is continued to be financed at an annual average rate of 6.8%.

With these assumptions, the year over year increase in revenues in 2014/15 is \$14 billion, increasing to \$15 billion in 2018/19. Program spending increases \$10 billion in 2014/15, with the year over year increase rising to \$12 billion in 2018/19. Debt charges are about flat over this period. Therefore, under this set of revenue and spending assumptions, with no fiscal action beyond the Budget 2009 plan, revenues increase \$3 or \$4 billion more than spending each year over the 2014/15 to 2018/19 period.

Starting with a deficit of \$13 billion in 2013/14, with the growing economy yielding a surplus, increasing by \$3 or \$4 billion per year, we can grow out of deficit in about 4 years beyond 2013/14. Therefore, we forecast the “growing out” option would yield a balanced budget by about 2017/18. See chart 6. This is 2 years sooner than forecast on the basis of the July

economic forecast. The conclusions and policy implications are, however, essentially similar.

Chart 6



With these assumptions, which I contend are the most reasonable assumptions to make, the government does not have a structural deficit. They can grow out of the \$13 billion deficit of 2013/14. Unfortunately however, it will take until about 2018 to grow out.

It is very important to note that the “growing out” option requires that the annual pace of program spending be kept below 5%. Otherwise, as each year passes, increases in program spending could exceed the increases in revenues and the deficit will grow rather than shrink as each year passes. This is a particularly critical consideration in the negotiation of the new federal-provincial health accord. Likewise it is critical that in any further stimulus spending or spending to help Canadians cope with the recession, that expenditures be temporary, ending before 2013. This is specifically relevant to the considerations to enhance EI benefits. For example, every additional \$4 billion dollars of spending in 2013, or after, delays the year of deficit elimination by another year.

Foregoing tax increases and growing out of the deficit should not be passed off as the “compassionate option.” It often is left to economists to be the “party poopers,” and this may be one of those occasions. If we do not increase taxes to eliminate the deficit in 2013/14, then we are not eliminating the problem - we will be passing the burden of the debt on to our children. To illustrate that there is a cost to future generations of “growing out” of the

deficit, as opposed to eliminating the deficit by tax increases, note some of the following statistics.

For starters, under the “growing out” option we would have deficits as opposed to balanced budgets over the 2013/14 – 2017/18 period. See chart 6. The debt burden (debt/NGDP) would be 27.4% rather than 26.0% in 2017/18. See chart 7. The debt would be about \$31 billion higher in 2017/18 under the “growing out” option. See Table 1. This higher level of debt would result in debt charges about \$5 billion higher cumulative over the 2013- 2017 period. Beyond that, the \$31 billion higher level of debt in 2017 would result in about \$2 billion more in debt charges for every year beyond 2018 - forever. That is, our children would be forgoing about \$2 billion in tax reduction or reduced program spending (or some combination there-of) each and every year, forever. This extra \$2 billion is solely due to the decision made to “grow out” of the \$13 billion deficit of 2013/14. Debt charges would be \$41 billion in 2012/13, compared to \$30 billion today, due to the recession and stimulus plan of 2009 and 2010, under either scenario.

### **Questions for Those Promoting the “Growing Out” Option**

- Are you willing and able to implement the tough spending restraints to permit the growing out option to be feasible?
- How many years do you plan to take to “grow out” of the deficit, and what contingency plans do you have if economic growth takes a dip, interest rates spike and/or energy prices plummet, throwing the deficit reduction plan off track?
- Why is it more appropriate to pass the costs of the 2009/10 recession and the stimulus plan on to our children, as opposed to imposing increased taxes in 2013 to eliminate the deficit?

### **Increasing Taxes to Hit the Budget 2009 Target for Deficit Elimination**

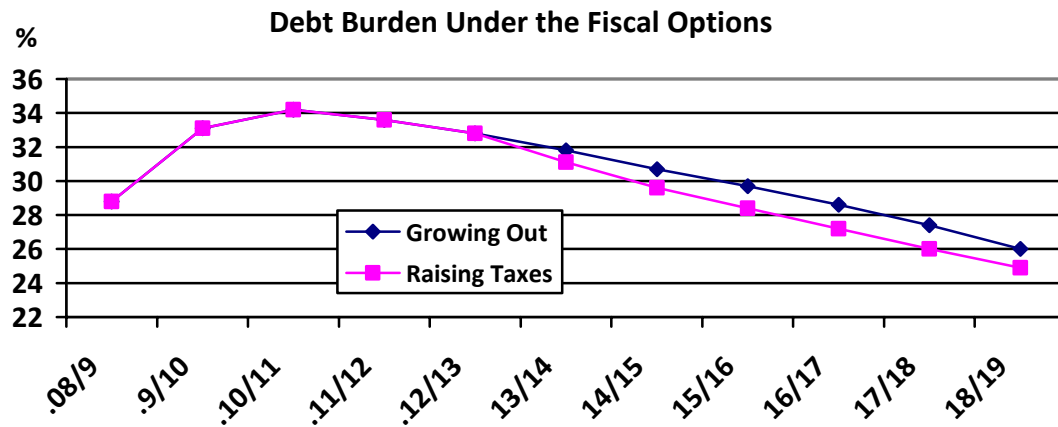
Another basic option would be for the government to increase taxes sufficiently to eliminate the deficit in 2013/14 as planned. This would require a tax increase of about \$13 billion to be imposed in 2013. Of course, there are many taxes which could be increased to raise the \$13 billion. From an economic performance perspective, one of the least damaging ways to raise the revenue would be to temporarily increase the GST back to the 7% level. This would yield about the \$13 billion required in 2013/14. A

temporary surtax on income tax, or on high income earners would be another possibility, possibly in combination, or to supplement the GST increase. One feature of this type of income tax is that it is more likely to gain the support of the Liberals and NDP, than most other forms of tax increase. If the GST were increased from the current 5% to 7% in 2013 to balance the budget in 2013/14, it could be lowered down to 6% in 2015 and back down to 5% in 2018, permitting the budget to be balanced (or slightly better) each and every year 2013/14 and onward.

From a political perspective, any plan to increase taxes to re-establish the deficit elimination date of 2013/14, or otherwise speed up deficit elimination significantly, seems unlikely. Prime Minister Harper has already announced his preference for the “growing out” option. Both Mr. Harper and Finance Minister Flaherty are firmly on the record against tax increases. Of course both are also firmly on the record against deficits and for favoring tough plans for deficit elimination. While Mr. Ignatieff can be expected to berate the government for missing their 2013/14 deficit elimination target, he is less likely to identify and support specific tax increases to accelerate deficit elimination.

Another argument against increasing taxes to eliminate the deficit significantly earlier than otherwise is that the federal debt burden will be well under control, even by the “growing out” option. In 2008/09 the debt burden (debt/NGDP) was 28.8%. Under the September economic forecast and the “growing out” option, this burden will increase to 34.2% in 2010/11 and fall about 1% point each year to hit 26% in 2018/19. See chart 7.

Chart 7



## Questions for Those Promoting the “Tax Increase Option”

- What specific taxes do you propose to increase and why should this particular group of taxpayers bear the burden of the deficits caused by the recession and stimulus plan?
- Why isn't it appropriate to pass some of the costs of these deficits on to our children, since some of the stimulus spending permitted infrastructure spending which they will benefit from?
- Why should taxpayers face a significant increase in taxes to accelerate elimination of the deficit? After all, Canada's federal debt burden will be very low by historical standards, even under the “growing out” option. See chart 7. Canada's total government debt burden will also be very low relative to some of the countries we compete with for international capital, such as the U.S., Britain and Japan.

**Table 1. Key Fiscal Indicators of the Fiscal Options (B\$)**

	2013/14	2014/15	2015/16	2016/17
<b>Budget Balance</b>				
Growing Out	-13	-9	-6	-3
Increasing Taxes	0	0	0	0
<b>Debt Level</b>				
Growing Out	601	610	616	619
Increasing Taxes	588	588	588	588
Difference	13	22	28	31
<b>Debt Charges</b>				
Growing Out	41	41.1	41.7	42.1
Increasing Taxes	41	40.2	40.2	40.2
Difference	0	0.9	1.5	1.9