

## **Some Insights to the Government's Economic and Fiscal Update**

The government rushed out an "Update of Economic and Fiscal Projections" on September 10, belatedly recognizing their Budget 2009 plan to eliminate the deficit in 2013/14 was off track, and providing some vague indications of their plans for eliminating the deficit over the medium term. The Update forecast deficits through 2014/15. The forecast is consistent with deficit elimination one or two years after that, but the forecast data stops with the 2014/15 year. The government was very clear that they would not impose tax increases or cut spending in several key areas, specifically transfers to individuals or other levels of government, to accelerate the timing of deficit elimination. Mr. Flaherty did emphasize that "Restraining the growth in government spending will still mean tough choices for the government." The purpose of this note is to examine what policy choices can be inferred from the data released in yesterday's Update.

A close examination of the forecast revenues and spending in the Update reveals that the revenue forecast, as well as the debt charges, over the 2012 – 2015 period are almost identical to those forecast in my "Economic and Fiscal Update" released Friday September 4. In my Update I assumed the government would increase program spending at an annual pace of about 4% per year over the 2012 – 2018 period. I consider a pace of 4% growth sufficient to cover all current commitments and expectations. It recognizes the increased pressures on spending resulting from the early stages of baby boomer retirements. At the same time, 4% program spending growth is not sufficient to provide for any significant spending on new priorities. The government's Update forecasts program spending growth of just under 3% over the 2012/13 – 2014/15 period.

While the forecast data (Table 1 of the Government's Update) reveal no plans to cut transfers to individuals or other levels of government, the federal government is clearly planning a distinct reduction in their generosity in other transfer payments. These are the transfers for regional benefits,

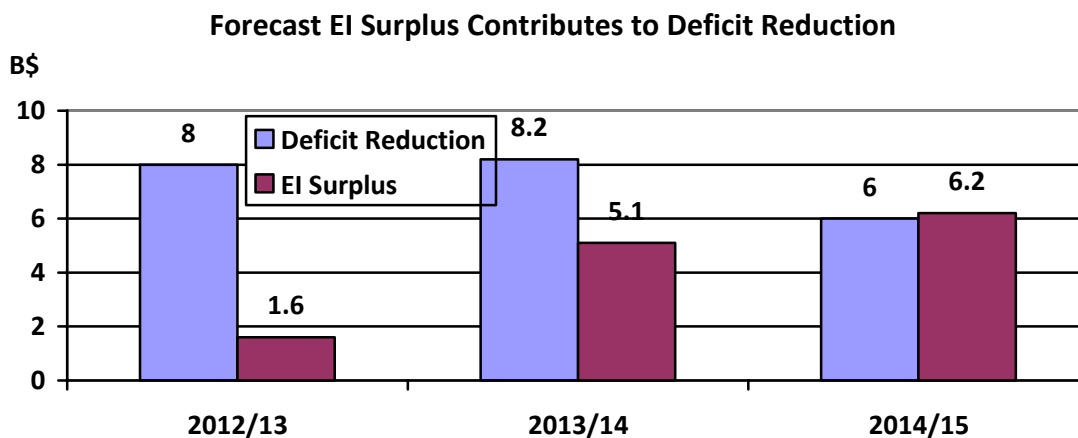
international programs, Industry Canada programs etc. Specifically, other transfer payments are planned to grow from \$32.8 billion in 2011/12 to only \$33.7 billion in 2014/15. This is a growth of only 2.7% cumulative over a three year period while the economy is growing 5.6% in real terms and the tax base (or Nominal GDP) is growing over 15%. Crown Agencies also come in for very tight spending control, with spending frozen at the \$7.6 billion level going forward.

When the Conservatives came in to power in 2006 they promised tight spending control. Over the 2006-2008 period when the economy was growing well, before the recession set in, the best they could do was to contain spending to a 7% annual growth pace. In spite of their claims to be tough managers of program spending, there is a distinct lack of accomplishment on this score. Furthermore, all the political opposition is on the left. Even with all the will in the world, how can this minority Conservative government survive if they plan to accelerate deficit elimination by tight spending control?

### **A Huge Surplus in EI Contributes to the Forecast Deficit Reduction**

The Update did not give any profile to the fact that the reduction in the forecast deficit benefits significantly from a huge and growing surplus in EI. The forecast fiscal deficit falls from \$27 billion in 2011/12 to \$5 billion in 2014/15, a reduction of \$22 billion. Forecast EI premiums exceed forecast

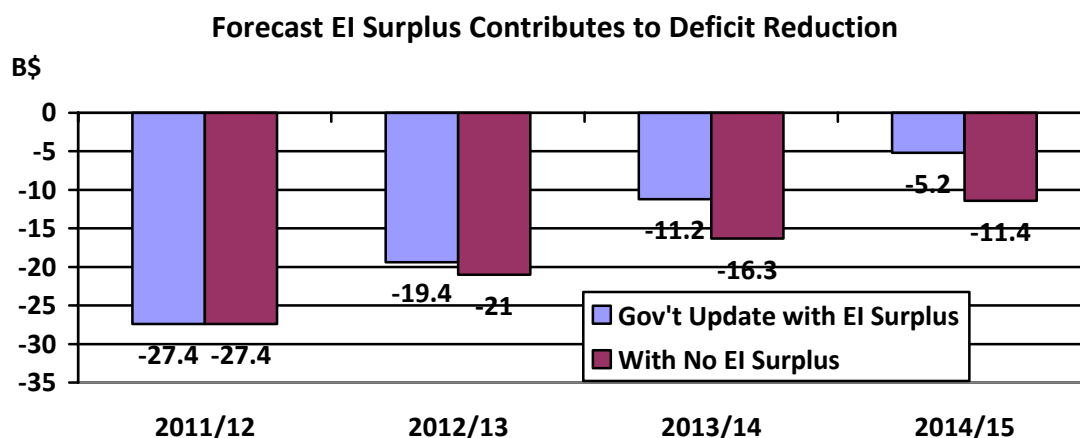
**Chart 1**



EI benefits (also adding in \$2 billion administrative expenses per year) by a cumulative total of \$12.9 billion over this period. Therefore the surplus in EI contributes significantly to the \$22 billion reduction in the total fiscal deficit over the 2012/13 – 2014/15 period. See chart 1.

Chart 2 presents this data from another perspective. If instead of building up the surplus in EI, EI premiums were reduced to eliminate the EI surplus in these years, the decline in the total fiscal deficit would not be as great. For example, without the benefit of the EI surpluses, the total fiscal deficit would be reduced to only about \$11 billion by 2014/15, as opposed to the \$5 billion forecast in the Update.

**Chart 2**



I have no quarrel with either the forecast of EI premiums nor forecast benefits, given the forecast of increasing levels of employment and reduction in the unemployment rate over this period. Also embedded in the forecast for EI premiums in the government's Update is an assumed increase in the EI premium rate in 2012. The EI surplus is meant to recover the deficit in EI this year and next caused by the recession. The EI components of the Budget 2009 stimulus plan are not recovered. This is consistent with current EI policy.

The recession, with employment falling and the number of unemployed skyrocketing, will cause deficits in EI over the 2009 – 2011 period. The government now plans to re-coup these losses partly by raising EI premiums in 2012, to compensate for the previous EI deficits. Some may argue that current policy is very unfair to working Canadians. They financed an

enormous EI surplus over the mid 1990's , which contributed heavily to the elimination of the deficit in 1997. After that EI surplus was contributed to debt reduction, the government then adopted a “break even over the economic cycle” policy for EI.

The Update gave no profile to the very significant role of the EI surplus of 2012 – 2014, in the forecast deficit reduction. As well, Mr. Flaherty pledged to return to balanced budgets without a tax increase. Isn't an increase in EI premiums a tax increase?