

Budget 2010: Can the Government Eliminate the Deficit? How? When? Who Cares?

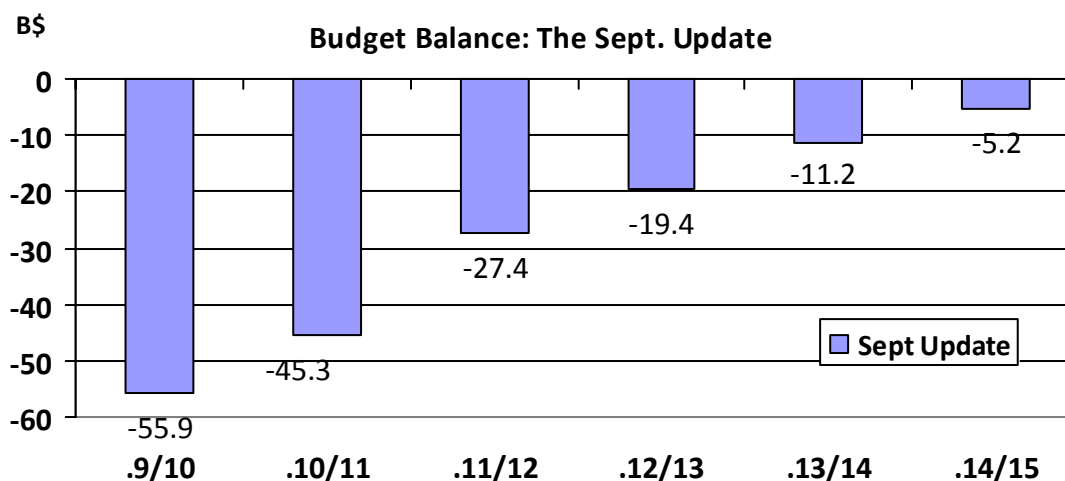
The government has told us to expect Budget 2010 on March 4 to reveal their plans to eliminate the deficit. Their basic approach was laid out in their September Economic and Fiscal Update. Since that time forecasts for the performance of the economy for this year and next have changed. Many very knowledgeable commentators, including several ex- Deputy Ministers of Finance have argued that their plans for spending restraint are either unrealistic or unwise. The Parliamentary Budget Officer has argued that the government has a “structural deficit,” making the government’s preferred route of relying on economic growth to rescue us from the deficit, unworkable.

The purpose of this report is to take account of all the data, information and perspectives which have arisen since the government’s September Update and provide a view on whether the government can or should balance the budget by the approach they have adopted.

The Government’s Plan to Eliminate the Deficit

On September 10 the government released its “Update of Economic and Fiscal Projections” (Update). 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 that they plan 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.

Chart 1



The Parliamentary Budget Officer Report

The Parliamentary Budget Officer's (PBO report) report of January 13 argued that the government is facing a structural deficit. This report forecast deficits very close to those of the September Update reported above over the 2009/10 through 2011/12 period, but forecasts considerably higher deficits in the 2012/13 and 2013/14 years. The PBO forecasts deficits of \$23 billion relative to the government's \$19 billion and \$19 billion relative to the government's \$11 billion in the outer years, respectively. Specifically, the PBO argues that this deterioration in the structural balance relative to potential income is largely due to lower revenues. Reductions in corporate income tax and GST rate reductions have pushed the projected level of structural revenues relative to potential income downward.

The PBO assumes that that the output gap is eliminated by 2014, that tax rates are as currently planned, and that, except for EI benefits, spending growth follows the government's current plan (different assumptions regarding EI benefits should not affect the forecast of the deficit since current policy calls for the EI account to be balanced over the cycle). These assumptions lead to the conclusion that the government will have a deficit of \$19 billion in 2013/14, and that deficit is a structural deficit. The implication of this structural deficit is that, going forward, revenues can be expected to fall short of spending and deficits will therefore increase. That is, the "growing out" option that the government favors is not possible under this set of assumptions by the PBO.

It is difficult to set the PBO's assumptions and conclusions directly against the government's fiscal plan in the September Update since the PBO did not provide a full fiscal forecast showing revenues, program spending and debt charges through 2014/15, as does the September Update.

Updating the Economic and Fiscal Forecast

Taking account of all of the new economic and fiscal data received since September, as well as factoring some of the points on fiscal relationships made in the PBO report, this section provides my updated economic and fiscal forecast.

Thankfully, the economic forecast has not changed significantly since September. Recall that federal budgets are based on the private sector economic forecast. I believe, barring any surprises over the next few weeks, my forecast (D. Orr Jan. 2010) will be close to the private sector consensus used in Budget 2010.

Today I, along with most economists, am forecasting -2.5% growth for 2009 relative to the -2.3% of the September Update. National Accounts data on 2009 will not be released until late February. It now looks like growth in 2010 will be about 2.6%, a bit stronger than the 2.3% forecast in the September Update. Nominal GDP, "the general tax base," in my January Update, is very similar to the forecast of the September Update, right through 2014.

When it comes to forecasting how much revenue the government can expect to extract from the economy in the outer years, I agree with the PBO that the government's September Update is a bit optimistic. However, I also believe the PBO is a bit pessimistic. My economic forecast going forward assumes that real GDP growth falls to only 2.4% in 2015 and there-after, recognizing the slow growth in employment.

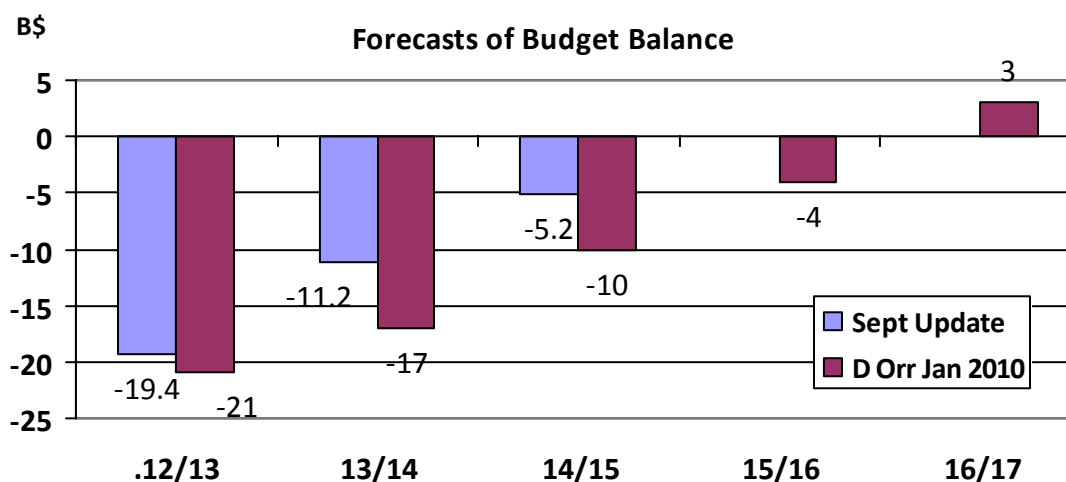
My revenue forecast does assume the government will not be able to extract quite as much revenue from the tax base in 2014/15 (rev/NGDP=15.1% vs. 15.3%) than does their September Update. I recognize the progressivity of the Personal Income Tax (PIT) however, and assume that, going forward, revenues will grow at a slightly faster pace than the tax base. This issue is particularly critical in evaluating the reasonableness of the "growing out" option. I agree with the government on the ability of economic growth to yield stronger revenue growth.

If the government can keep the growth of program spending to the 3% pace as they plan in 2013/14, and going forward, I do not believe they have a structural deficit. The issue of whether the government has a structural deficit is a very complicated one, resting on assumptions regarding potential output, the output gap and the revenue yield to the government from growing levels of income.

As has been its custom for years, in Budget 2010 the government can be expected to use the private sector consensus as its economic forecast, which is the key driver of the revenue forecast. The most important criticisms of the government's fiscal plan to date have been focused on its plans for spending restraint. Specifically, the implications of that restraint and the realism of the targets. This, I argue, is a much more productive area upon which to focus than focusing on whether the government does or does not have a structural deficit. At the end of the day, if the government can sufficiently restrain its spending it will balance the budget without a tax increase. If it can't restrain its spending sufficiently, it cannot.

These revenue assumptions, and assuming program spending grows at a 3% per year pace as planned in the government's September Update, lead to forecast deficits slightly larger than those of the government's September Update in the outer years. Most importantly, I forecast the government will have a deficit of about \$10 billion in 2014/15, rather than the \$5.2 billion which they forecast. My updated economic and fiscal forecast yields a deficit of \$4 billion in 2015/16 and a surplus of \$3 billion in 2016/17.

Chart 2



The slightly larger deficit forecasts in the outer years in the “D Orr Jan 2010” update,” than in the government’s September Update shown above, originate entirely on the revenue side since, above, I have adopted the government’s spending assumptions. The \$5 billion larger deficit in 2014/15 results primarily from my assumption of a lower yield in federal income tax from the tax base, rather than a weaker economic forecast.

From the updated economic and fiscal forecast I conclude that, if the government can keep program spending growth to the 3% pace which they currently plan, they cannot balance the budget in 2015/16, but they probably can the following year. That is, I believe the “growing out” option, with no tax increases and spending growth restrained to the 3% level, can lead to the elimination of the deficit. However, the realism of some of these assumptions definitely must be called into question.

Is the Government’s Plan Realistic?

I argue that the government’s plan is not realistic on either the revenue or the spending side. Furthermore, it is misleading, and beyond that, it is not the best route to deficit elimination.

First, the government’s claim that they plan to eliminate the deficit with no tax increases is simply misleading. As was argued in detail my October report, “How EI Increases Speed Up Deficit Reduction,” embedded in their September plan is a whopping increase in EI premiums. To be specific, their September Update plans for EI revenues to rise sharply over the 2011-2104 period, yielding about \$13 billion in surplus in the EI account. These increases in EI revenues are a compulsory deduction from our paychecks, at a higher EI premium rate than currently exists, yielding about \$13 billion more in revenue to the government than would have been collected at today’s rates. That sure sounds like a tax increase to me – and a very large one. Yet the government continues to claim they will eliminate the deficit without any tax increases.

The government has been advised by several knowledgeable experts that their plans to keep program spending growth at 3% are unrealistic. First, I want to emphasize that I believe the government can put forward a fiscal plan to restrain program spending to 3%. The important questions are not whether the government can put forward a plan, in Budget 2010 or otherwise, to restrain program spending growth to 3%. After all, in 1994 Finance Minister Paul Martin put forward a plan

to actually cut program spending - and accomplished it. The important questions are:

- If this minority government presents a plan with severe spending restraint in Budget 2010, is there a realistic probability this plan will be accepted by Parliament? If not, then what happens?
- If the government does not restrain program spending quite so severely, how long will it then take to balance the Budget?

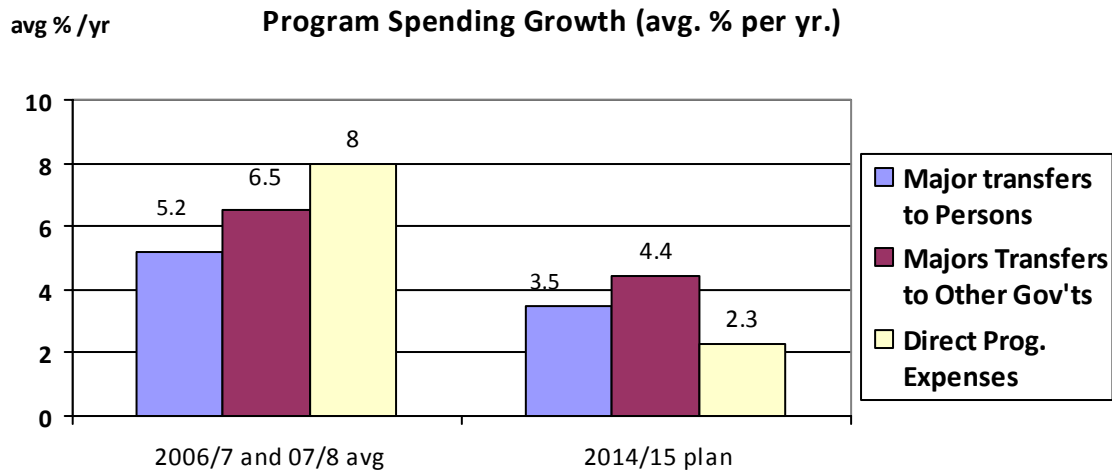
We next turn to these questions.

Whether this Parliament will pass a budget with a 3% spending plan in it is, of course, an issue primarily for the political pundits, as opposed to an independent economist. However, to provide some information for the pundits, an examination of what such a plan might look like will hopefully be a contribution to this political debate.

The government plans to “protect the growth track” of major transfers to persons as well as to other levels of government. Therefore the restraint will be focused on the only other category of federal program spending, “direct program expenditures.” Before moving to a discussion of direct program expenditures it is important to note that over the 2006 – 2008 period, while this government was in power and before the recession, transfers to the other levels of government grew at an annual pace of 6.5%. The government’s September Update has transfers to other levels of government growing at only about 4.4% in 2014/15. However, provinces will be under even more pressure from a rapidly aging population in 2014 than they were in 2007, due to the pressure on their health care responsibilities. To provide for a pace of growth more consistent with their stated position (i.e. 6.5%), would cost the federal government over a \$1 billion more in 2014/15 and every year going forward, than what they are currently planning for.

We next turn to direct program spending. Assume transfers to other levels of government grow at the more realistic 6.5% pace and we accept the planned pace of growth of transfers to persons of 3.5%. Then, in 2014/15, to meet the 3% pace of growth in total program spending, direct program spending would have to grow just under 1%. This tight, under 1%, growth in direct program spending would have to be maintained each year going forward to keep total spending growth to a 3% pace.

Chart 3



The government certainly can put forward a plan in Budget 2010 for direct program spending growth to be just under 1%. But it is important to realize the complexion of this plan. Direct program spending is just under half of total program spending. Some parts of the direct spending may be even more sensitive than the transfers which have already been “taken off the table.” Last year defense spending was about 19% of direct program spending. First Nations and Inuit programs were the next largest component at 7%. Several other categories are covered by legislation or longer term agreements. (eg. Atlantic Canada Revenue Accord, CMHC funding). Reductions in other components of direct program spending would not reduce the deficit since they are tied to revenue collections (EI Administration). One of the largest categories remaining is personnel costs of about 27%. Freezing salaries of public servants until the deficit was eliminated could well be the least unpopular area for Mr. Flaherty’s hatchet, but that would save only about a half billion per year. The only way to make serious saving in this category is to leave upcoming vacancies unfilled and or to layoff public servants. However, what about the previously urgent priority of “public service renewal.” Freezing salaries and understaffing would seem to fly in the face of keeping and attracting the brightest and the best to the public service.

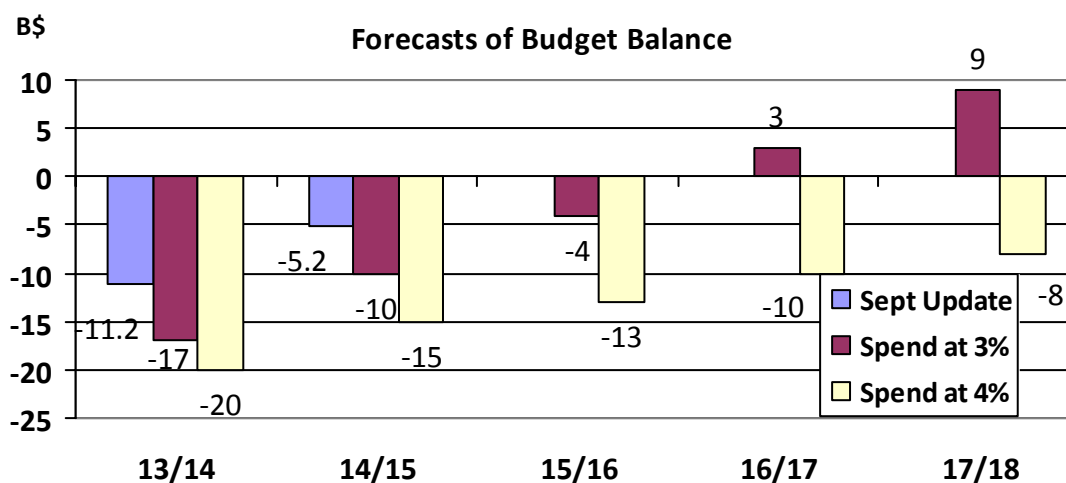
It is interesting to note in the early days of this government, in the pre-recession era (2006-2008), the pace of growth in the direct spending category was even greater (8%) than that in either the transfers to persons (5.2%) or to other levels of government (6.5%). Whether this generous earlier treatment makes restraint in this category easier now or not is a debatable point.

With these insights, I leave it to the political pundits to argue whether this minority government could pass a budget through Parliament which includes plans for direct program spending to grow at less than 1% over a period of several years.

What if Spending Restraint is Not So Severe?

We next examine how much longer it would take to eliminate the deficit if program spending were to grow at a 4% annual pace as opposed to 3%, from 2013/14 onward. Until about 2012, the government will be winding down the stimulus program and ensuring the economy is fully recovered. As well, some restraint programs require a good lead time. Therefore, this analysis will consider potential changes to the program spending track beginning with the 2013/14 year.

Chart 4



From Chart 4 we observe that if program spending grows at 4% instead of 3% per year from 2013/14 onward, it pushes the date of deficit elimination much further forward. A 1% point difference may not sound like much, but the impact becomes progressively important as time goes on. While we forecast the deficit would be eliminated in 2016/17 if program spending were restrained to 3% growth per year, at a 4% pace it would not be eliminated until 2020/21.

To further emphasize the sensitivity of the deficit track to apparently small changes in the pace of program spending, consider, momentarily, what happens if spending were to grow at 5% instead of 4%. Obviously, if program spending were growing at a 5% pace, as opposed to 4%, the deficit in 2014/15 would be well above the \$15 billion level which results at the 4% pace. Then, going forward, the pace of

program spending at 5% would exceed the pace of revenue growth. In such case, every year, deficits would grow at an increasing rate. At a 5% spending pace the government would have a structural deficit.

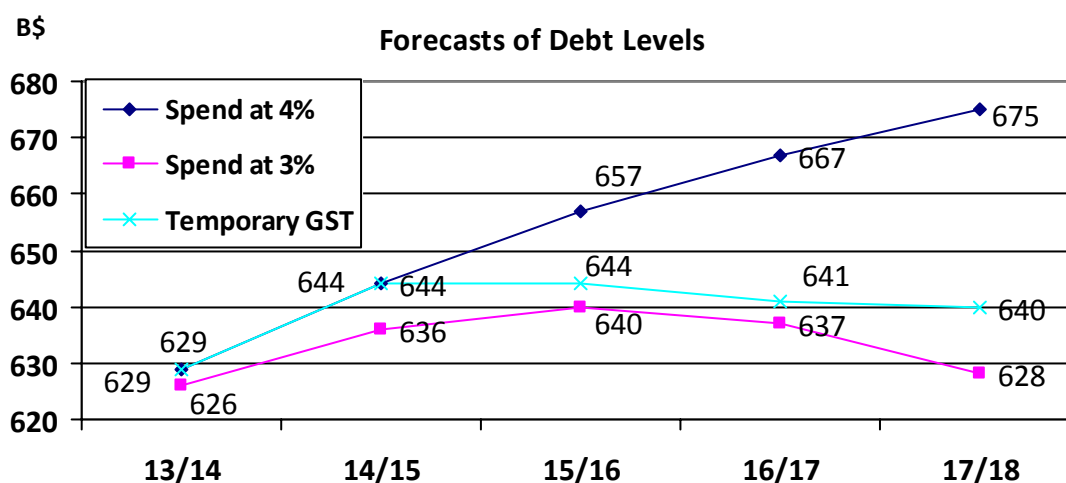
The key lesson from this simulation is to note how much difference it makes to the date of deficit elimination to be able to restrain program spending to 3% growth as opposed to 4%. The “tyranny of small differences,” is often evident in economic analysis when numbers are compounded year after year. This is a good example.

Who Cares?

It appears the federal public servants have the most to lose if the government opts for the tight 3% spending track. Obviously, those depending on the services these public servants would be providing, (eg. industrial, regional and international support programs) would also be hurt.

If the government opts for a less severe restraint program, these victims may not suffer quite so much, but the date of deficit elimination would be pushed outward considerably. To examine who is hurt by a later date of deficit elimination we examine the level of debt under these two options.

Chart 5



As the date of deficit elimination is pushed forward, the level of debt at the date of deficit elimination is higher. The impact of a higher level of debt is that a higher level of debt charges is passed on to future generations. Under the 3% spending scenario the deficit is eliminated in 2016/17, with debt peaking at \$640 billion the

year before. If the 4% spending path is chosen, then the deficit isn't eliminated until 2020, with debt peaking at \$680 billion. The \$40 billion in extra debt built up due to the more leisurely pace would result in debt charges of almost \$3 billion being passed on to future generations for every year going forward (assuming a balanced budget after 2016/17 in the 3% scenario). This would require our children to pay \$3 billion more in taxes and/or forego \$3 billion in program benefits every year or some combination there-of.

In my earlier October paper “The Path to Deficit Elimination: The Growing Out Option is Too Risky.” I recommended the government implement a temporary increase in the GST to eliminate the deficit. The justification for this temporary increase in the GST is fourfold.

- It speeds up the date of deficit elimination significantly, reducing the risk that some urgent spending priority or economic downturn would knock us off the deficit elimination path before we got there.
- It could ease the burden of the severe restraint implicit in the 3% spending growth path, permitting the 4% spending path.
- Recognizing the government has, in its current plan, a whopping tax increase in EI premiums, the temporary GST increase could be substituted for that less economically efficient “tax on jobs.”
- By speeding up the date of deficit elimination it leaves a smaller amount of debt to be passed on to future generations.

In this “temporary GST” scenario I assume the government continues with the EI premium hikes, but opts for the less severe 4% growth in program spending restraint. They move the GST up to the 7% level in April 2015, eliminating the deficit in that year, as opposed to the \$13 billion deficit they would otherwise have. The GST can be reduced to the 6% level in April 2017 and moved back down to 5% in April 2018. This plan brings deficit elimination in 2015/16 while permitting the less severe 4% spending track.

This recommendation was made in my October paper on its merits as sound economic policy. At the time I emphasized that I did not expect it to have political appeal. Mr. Flaherty has not disappointed, explicitly rejecting this plan, in spite of the fact that, since October, several other economists, including several ex- Deputy Ministers of Finance, and even a former Minister of Finance, have encouraged the government to consider this option.

Of course, if the government opts for the temporary GST hike, consumers over the 2015 – 2018 period will pay more. However, there is some justification for speedy elimination of the deficit. Lifting the debt burden on future generations is fair since the debt was built up primarily in 2009 and 2010, and much of it due to the stimulus plan the government implemented to ease the burden of the recession. When we pass higher debt charges onward we are also making it harder for governments to finance the significantly higher health care benefits which our generation will be demanding.

Conclusions

- The purpose of this report is to take account of all the data, information and perspectives which have arisen since the government's September Update and provide a view on whether the government can or should balance the budget by the approach they have adopted. Who is most affected by their choice of deficit elimination options?
- If the government can sufficiently restrain its spending it will balance the budget without a tax increase. If it can't restrain its spending sufficiently, it cannot.
- The revenue assumptions resulting from the updated economic forecast, and assuming program spending grows at a 3% per year pace as planned in the government's September Update, lead to forecast deficits slightly larger than those of the government's September Update in the outer years.
- From the updated economic and fiscal forecast I conclude that, if the government can keep program spending growth to the 3% pace which they currently plan, they cannot balance the budget in 2015/16, but they probably can the following year. That is, I believe the "growing out" option, with no tax increases and spending growth restrained to the 3% level, can lead to the elimination of the deficit.
- I argue that the government's plan is not realistic on either the revenue or the spending side. Furthermore, it is misleading, and beyond that, it is not the best route to deficit elimination.

- One of the key conclusions of this report is how very sensitive the deficit reduction track is to seemingly small changes in the pace of program spending growth. A 1% point difference may not sound like much, but the impact becomes progressively important as time goes on. While we forecast the deficit would be eliminated in 2016/17 if program spending were restrained to 3% growth per year, at a 4% pace it would not be eliminated until 2020/21. If spending growth were sustained at 5%, the pace of program spending would exceed the pace of revenue growth. In such case, every year, deficits would grow at an increasing rate.
- Another key conclusion of this report is the identification of how difficult (unprecedented for them, politically difficult) it will be for this government to hold program spending to 3% growth on a sustained basis. It appears the federal public servants have the most to lose if the government opts for the tight 3% spending track. Obviously, those depending on the services these public servants would be providing, (eg. industrial, regional and international support programs) would also be hurt by this option.
- In my October report I recommended the government implement a temporary increase in the GST to eliminate the deficit. This revenue raising approach could eliminate the deficit as early as the 3% spending restraint approach, with less spending restraint, and likely be less harmful to our economic growth prospects.
- There is some justification for speedy elimination of the deficit. Lifting the debt burden on future generations is fair since the debt was built up primarily in 2009 and 2010, and much of it due to the stimulus plan the government implemented to ease the burden of the recession. When we pass higher debt charges onward we are also making it harder for governments to finance the significantly higher health care benefits which our generation will be demanding.