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THE FEDERAL BUDGET: EXPLAINING THE TURNAROUND

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OVERVIEW

In the 2003-2004 fiscal year, the federal government posted a budgetary surplus of $9.08 billion, equivalent to 0.7% of Canada's Gross Domestic Product (GDP). Since ending almost 30 years of uninterrupted budgetary deficits with its first budgetary surplus in 1997-1998, the federal government has generated a total of $61.36 billion in budgetary surpluses.(1) There is still debate about how this budgetary turnaround was achieved.(2) This paper looks at some of the main explanations.

BUDGETARY FACTORS

Before looking at the reasons behind the budgetary turnaround, it is important to have a clear understanding of what is meant by terms such as budgetary balance. The federal government's budgetary balance refers to the difference between the federal government's total tax revenue and its total spending, including the interest costs on the public debt. The budgetary balance is different from the operating balance, which is defined as total tax revenue less program spending. In other words, the operating balance excludes interest costs. Table 1 illustrates these terms with the help of budgetary data from the 2003-2004 fiscal year.

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(1) Author's calculation based on data from the Department of Finance publication *Fiscal Reference Tables, October 2004*, available at: http://www.fin.gc.ca/toce/2004/frt_e.html. Note that these figures reflect the federal government's new, full-accrual accounting methodology.

(2) For a recent contribution, see Thomas Courchene, "Half-Way Home: Canada's Remarkable Fiscal Turnaround and the Paul Martin Legacy," *Policy Matters* (Institute for Research on Public Policy), Vol. 3, No. 8, July 2002.

Table 1: Some Key Budgetary Concepts
($millions)

	2003-2004 Fiscal Year
Budgetary Revenues	$186,207
Less: Program Expenses	$141,355
Equals: Operating Balance	$44,852
Less: Interest Costs	$35,769
Equals: Budgetary Balance	$9,083

Source: Library of Parliament and Department of Finance, *Fiscal Reference Tables 2003-2004*.

A. Revenue

Between 1997-1998 and 2003-2004, federal government revenue grew less quickly than the overall economy, increasing by 22.4% compared with a 37.7% increase in nominal GDP.(3) As a result, federal revenue as a percentage of GDP fell from 17.2% in 1997-1998 to 15.3% in 2003-2004, the lowest level since 1979-1980. This represents a significant break with the past, when federal tax policy helped play an important counter-cyclical role: in periods of strong economic growth, federal government revenues tended to grow more quickly than the overall economy because of increases in employment income, profits, and capital gains, all key sources of federal tax revenue. Consequently, federal revenue as a percentage of GDP tended to increase. The reverse was true during economic downturns and recessions, when federal revenues grew more slowly than the overall economy.(4)

The main reason behind the most recent fall in federal tax revenue as a percentage of GDP appears to be related to tax cut measures announced in the 2000 budget, rather than slower economic growth. These measures included a reduction in marginal tax rates, increases in basic personal exemption amounts, and full indexation of all tax brackets.

The latter half of the 1990s also signalled a broader conceptual shift away from delivering new social policies through program spending, and towards the delivery of social policy through the tax system. The 1997 budget, for example, introduced the (refundable)

(3) Nominal GDP is GDP before the output is adjusted to reflect the impact of inflation. Quarterly GDP figures from Statistics Canada's CANSIM II Web site (CANSIM Table 380-0001, series v498906) were used to make the appropriate comparisons.

(4) Following the recession in the early 1980s, for example, federal revenue as a percentage of GDP increased from 15.5% in 1983-1984 to 17.1% in 1987-1988, just before the economy started to slow in advance of the 1990-1991 recession.

Canada Child Tax Benefit (CCTB).[5] The CCTB was increased in subsequent budgets. Similarly, most budgets from the latter half of the 1990s offered increased financial assistance to students, again largely in the form of tax incentives such as a new tax credit for student loan interest payments, increased exemptions on scholarship income and a number of other related measures.

To summarize, while tax revenue growth contributed to the federal government's budgetary surpluses between 1997-1998 and 2003-2004, the contribution was markedly less than it had been in the past, in part because of a shift towards increasing use of the tax system to deliver social policy and in part because of tax cuts announced in the 2000 budget.

B. Program Spending

On the program spending side of the budgetary equation, some argue that the federal government's surpluses can be explained in part by its concerted efforts to restrain spending. Queens University economist Thomas Courchene, in an analysis of how the federal government moved from deficits to surpluses, says that "much of the progress in terms of eliminating the federal budget deficit was engineered by transferring or offloading the deficit to the provinces, via a dramatic cut in their cash transfers … in recent years this cut has been restored in dollar terms, but not as a percentage of GDP."[6] At the same time, a number of powers were also transferred to the provinces, including "parts of tourism, forestry, mining, training, etc. – but not a corresponding transfer of appropriate finances ..."[7]

One way of gauging the federal government's spending is to look at program spending as a percentage of GDP: it has averaged about 11.5% since the first budgetary surplus was recorded in 1997-1998, compared with an average of 16.2% in the previous 36 years. Again, as Courchene suggests, much of the explanation for this decline can likely be attributed to policy changes in the mid-1990s, including not only reduced transfers to the provinces but also the imposition of more stringent eligibility criteria for the federal government's employment insurance program, plus wage freezes and cutbacks to the public service.

Finally, it is important to recognize that spending restrictions from the mid-1990s and onward continue to exert an influence today, especially with regard to employment

(5) The CCTB was built on the old Child Tax Benefit.

(6) Courchene (2002), p. 23.

(7) *Ibid.*

insurance, the public sector wage freezes,[8] and ongoing negotiations between the federal government and the provinces over transfer payments.

C. Interest Costs

The last six years of federal budget surpluses would hardly be noteworthy if it were simply a matter of looking at the difference between budgetary revenue and program spending. The federal government has been generating consistent operating surpluses since 1987-1988, having incurred operating deficits only during a period extending from 1975-1976 to 1986-1987.

For most of the last 30 years, *rising* debt costs have played a decisive role in pushing the federal government into a budgetary deficit. It is not surprising, then, that the recent string of budgetary surpluses can be attributed in large part to *falling* debt costs. In 2003-2004, the federal government spent about 12.5 cents of each tax dollar on interest costs from its market debt, down from a high of 27 cents in 1995-1996.[9] As a percentage of GDP, market debt charges were 1.9% in 2003-2004, less than half the peak of 5% in 1990-1991.

The main reason for the decline in interest costs is lower interest rates. Between 1997-1998 and 2003-2004, the average interest rate on the federal government's market debt fell more than 26%, from 6.64% to 4.91%. If the average interest rate in 2003-2004 had instead been 6.64%, the level prevailing in 1997-1998, federal market debt costs would have been $29.2 billion, or $5.8 billion more than actual interest costs in 2003-2004;[10] and the 2003-2004 budgetary surplus would have been only $445 million, 14 times less than its actual amount of $6.35 billion.

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(8) In order for the public sector wage freeze to have been "undone," federal government unions would have had to secure some sort of compensatory wage increases following the lifting of the wage freeze. It is difficult to say whether this in fact happened. Statistics Canada wage settlement data (Table 278-0007, series v4327246) suggest the federal wage freeze began in 1992 and ended in the first quarter of 1997. Subsequent wage increases were generally somewhat in excess of inflation, but probably not substantial enough to erase five years of zero wage increases.

(9) Market debt is the only kind of debt the federal government can truly "pay down." Non-market debt consists of government employee pension plan obligations, the federal government's Canada Pension Plan obligations, and accounts payable, none of which can be repaid "at will" by the federal government. Note also that market debt plus non-market debt equals gross federal government debt.

(10) The $29.2-billion estimate was calculated by applying the 6.64% average interest rate prevailing in 1997-1998 to the federal government's 2003-2004 outstanding market debt of $440.2 billion. Note also this estimate almost certainly underestimates the true cost of the debt if the average interest rate had been 6.64%, because of the federal government's changing debt structure (discussed later in this paper).

The situation in 2003-2004 looks all the more sanguine compared with the late 1980s and early 1990s, when the average interest rate on the federal government's market debt was more than double the 2003-2004 rate, reaching a high of 11.2% in 1989-1990.(11) If the 1989-1990 average interest rate had prevailed in 2003-2004, the federal government's market debt costs would have been an estimated $49.3 billion, or $25.9 billion more than they actually were, and the federal government would have posted a $19.6-billion deficit instead of a $6.35-billion surplus.

To be sure, the federal government's interest costs might have been even lower had the Department of Finance held to what is called the 50-50 formula, whereby 50% of federal debt consisted of short-term liabilities such as treasury bills with a maturity of less than 3 years, and 50% consisted of longer-term debt with maturities ranging from 3 through to 30 years.(12) Instead, the Department of Finance increased the portion of long-term debt to two-thirds in order to "provide more cost stability in an environment of fiscal and current account deficits, volatile interest rates and high debt levels."(13) The decision proved costly in the context of falling interest rates, although it was understandable given the high and volatile interest rate environment of the late 1980s and early 1990s. In the 2003 budget, the federal government announced its intention to reduce the share of long-term debt to 60% from 66.6%, based on a belief that the current low-inflation, low-interest-rate environment will continue for the foreseeable future. The Department of Finance estimates this reduction will save the federal government up to $750 million during the five-year transition period and up to $500 million, on average, per year thereafter.

Lower interest rates are not the only reason for the federal government's lower debt costs. The Department of Finance estimates that by reducing federal market debt by $37.1 billion since 1996-1997, the federal government has saved $3 billion a year on average.(14)

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(11) These data are from the Department of Finance's *Debt Management Report 2002-2003*, Reference Table 1, available at: http://www.fin.gc.ca/toce/2003/dmr03_e.html.

(12) This distinction between short-term and long-term debt is taken from the glossary section of *The Canadian Securities Course Textbook*, Canadian Securities Institute, Toronto, 1992, p. 438. The Department of Finance does not provide a similarly simple and clear definition in its publications.

(13) Department of Finance, *Debt Management Report 2002-2003*, p. 37.

(14) *Ibid.*, p. 9.

FORECASTING METHODOLOGY

Finally, the federal government has also been able to generate surpluses because of its forecasting policy. Queens University's Courchene argues there are several reasons for persistent discrepancies between forecasts and actual performance, including the budget process itself, which was radically altered shortly after the Liberals came to power. The new budget process is built on four pillars:

1. Adopting a three-year forecasting horizon instead of the five-year forecasting outlook used in the past;
2. Using the average of private-sector forecasts rather than relying on purely in-house assessments of the economic outlook;
3. Using "prudent" values for key parameters from private-sector forecasts. This amounted, essentially, to raising the forecast interest rate and lowering the forecast GDP growth rate relative to the consensus.
4. Creating the conceptual "contingency reserve" and "economic prudence" accounts to absorb forecast errors.

By adopting this methodology – and by emphasizing the difficulty in accurately forecasting the behaviour of a system so complex as a national economy – the federal government imposed a sort of self-discipline on its spending and taxation policies, using the conservative fiscal estimates to deny requests for spending increases or tax cuts that might jeopardize its estimated surplus.

MACROECONOMIC FACTORS: THE U.S. ECONOMY

Canada's fiscal turnaround did not happen in a vacuum. The first surpluses were recorded in the context of strong economic growth and import demand in the United States combined with a relatively weak Canadian dollar. Even when the U.S. economy weakened and moved into a shallow recession in 2001, Canadian firms fared reasonably well, sustained by continued strong U.S. demand for foreign goods – especially Canadian products related to energy, forestry and automobiles.(15) As economist Wynne Godley has noted, the U.S. income

(15) In 2001, Canada recorded a record merchandise trade surplus (with the world) of $62.5 billion, due entirely to a $97.1-billion trade surplus with the United States (Canada recorded trade deficits with other countries, hence the lower overall surplus). The bulk of the surplus was due to surging energy exports. Forestry and automotive exports continued to play their part, but their contribution to the overall trade surplus with the United States and the world was less than in the late 1990s and 2000. Source: Statistics Canada, *Canadian Economic Observer*, February 2004, Tables 19 and 20.

elasticity of demand for imports is "very high and far in excess of the foreign income elasticity of demand for U.S. exports."(16) In other words, a small increase in income – even the kind of small increases typical of an economy moving out of recession – can drive large increases in demand for foreign goods, particularly those related to basic needs such as housing and energy.

Moreover, the U.S. federal deficit – which in 2003 was 3.5% of GDP, and was expected to increase to 4.5% of GDP in 2004(17) – has, according to Godley, probably played an important role in helping the U.S. economy recover from the 2001 recession and, by implication, in sustaining demand for Canadian goods. Godley notes, for example, that the potentially dire effects of the 2001 U.S. economic recession were "mitigated by a transformation in the stance of fiscal policy, accompanied by a radical change in attitudes toward budget deficits, which suddenly became respectable."(18)

With 82% of Canada's merchandise exports going to the United States,(19) the Canadian economy – and hence the federal government's ability to generate tax revenue – is sensitive to changes in the U.S. economy. The relationship between the performance of the Canadian and U.S. economies is illustrated by comparing annual real GDP growth rates, as shown in Figure 1. In that light, U.S. demand for Canadian goods has been strong, and likely will remain strong so long as the U.S. economy does not suffer a serious recession.(20)

CONCLUSION

The evidence seems to suggest that while increased tax revenues and spending cutbacks played a key role in the fiscal turnaround,(21) most of the federal government's historical and ongoing ability to generate surpluses can be explained by lower interest costs on its debt. At the same time, strong U.S. growth, followed by budget deficits, provided the necessary economic backdrop for these surpluses to happen.

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(16) Wynne Godley, *The U.S. Economy: A Changing Strategic Predicament*, The Levy Economics Institute of Bard College, Annandale-on-Hudson, N.Y., March 2003, p. 3.

(17) *Economic Report of the President 2004*, p. 378. The U.S. fiscal year runs from 1 October to 30 September.

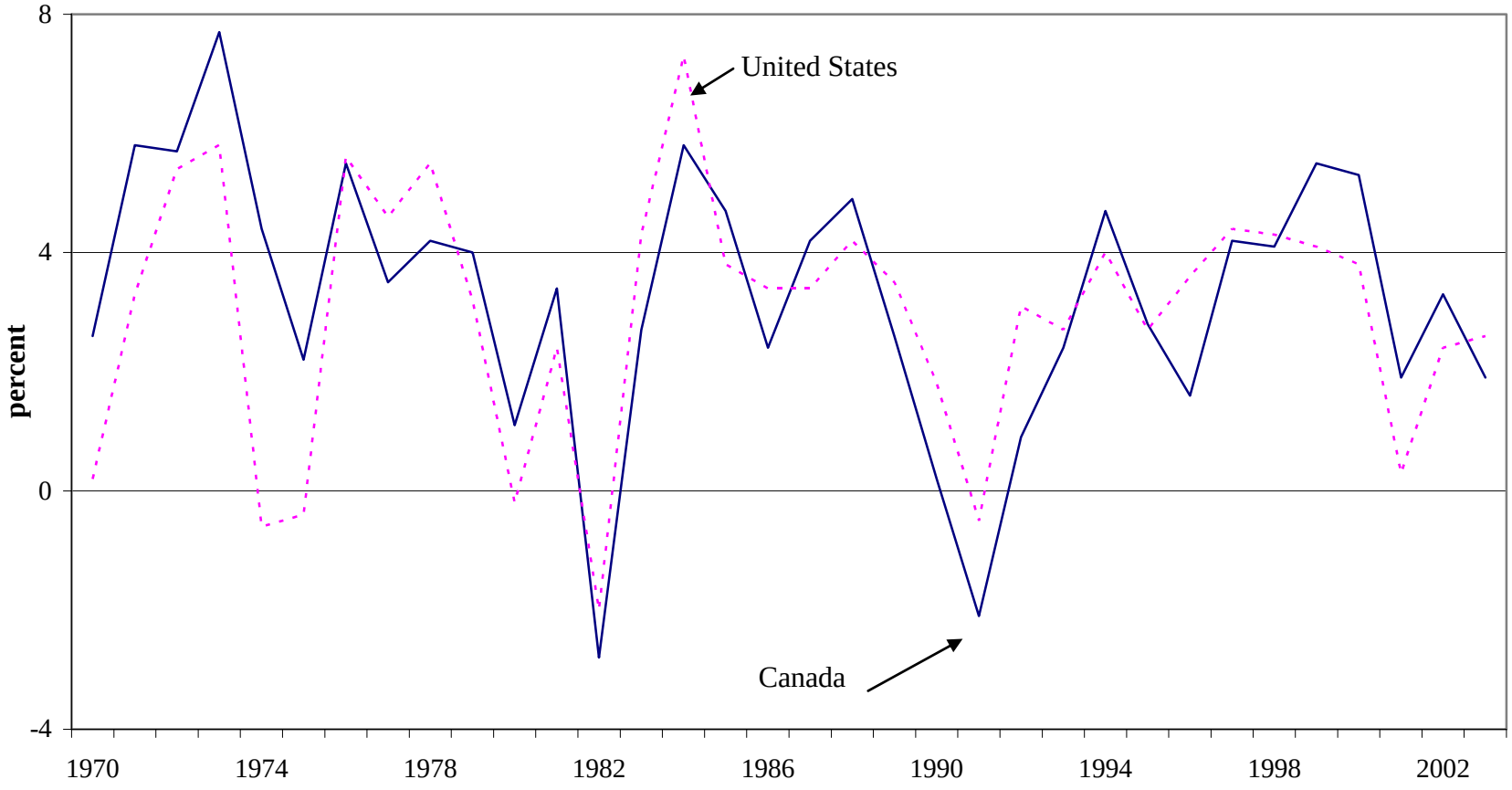
(18) Godley (2003), p. 1.

(19) This figure is for 2004 and was calculated by dividing total goods exports to the United States ($351.9 billion) by total exports worldwide ($430.4 billion). Source: Statistics Canada, *Canadian Economic Observer*, April 2005.

(20) A serious recession would have a symmetrical and opposite affect given the U.S. economy's high import elasticity, leading to a sharp decline in demand for Canadian and foreign goods.

(21) As noted, the budgetary process itself may have also played a role in the budgetary turnaround by providing a handy rationale for resisting public pressures to increase spending or cut taxes.

Figure 1: The Ties that Bind: Real GDP Annual Growth Rates for Canada and the United States



Source: International Monetary Fund World Economic Outlook, September 2003, and Library of Parliament.