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THE EVOLUTION OF FEDERAL GOVERNMENT FINANCES, 1983-2003

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THE EVOLUTION OF FEDERAL GOVERNMENT FINANCES, 1983-2003

INTRODUCTION

This document provides a historical overview of the evolution of federal finances. The chosen time frame was a period of turnaround, including notably the return to budgetary surpluses in 1997-1998. The evolution is analyzed using simple performance indicators that are found in accountability documents such as the Public Accounts of Canada, the Annual Financial Report of the Government of Canada (prepared by the Department of Finance) and other publications prepared by various economic and budget forecasting organizations. Many of these indicators are described in a Canadian Institute of Chartered Accountants research report published in 1997.(1) They can be classified according to three criteria: sustainability, flexibility and vulnerability. For the sake of simplicity, this publication will focus on sustainability and flexibility indicators.

The following analysis covers a 20-year period in order to include at least one complete economic cycle. Financial data are compiled on a uniform accounting basis (full accrual) to ensure comparability and consistency in the analysis.

SUSTAINABILITY

A. Net Debt-to-GDP Ratio

When government expenditures exceed government revenues, a budgetary deficit results; and vice versa for a surplus. A government's public debt is defined as the sum of all the budgetary surpluses and deficits it has accumulated over a specific period of time. In the case of Canada, the federal government's public debt is the accumulation of budgetary surpluses and deficits since Confederation, in 1867.

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(1) Canadian Institute of Chartered Accountants, Research Report, *Indicators of Government Financial Condition*, Toronto, 1997.

Federal government debt consists of interest-bearing debt and other liabilities, net of financial and non-financial assets. Interest-bearing debt, in turn, consists of unmatured (or market) debt and the government's obligations to internally held accounts – primarily liabilities for federal employees' pension plans.

In terms of government expenditure management, "servicing the debt" involves paying interest charges and reimbursing the portion of the debt that comes due. Managing the federal debt is a priority for government financial administration because defaulting on debt service payments downgrades the government's credit rating. This in turn raises the cost of borrowing and discourages creditors and other potential lenders from refinancing or "rolling over" the government's existing stock of debt, or extending further credit.

The amount of debt burden a country can support depends on the economy's capacity for growth and the government's capacity to raise revenues, service its debt, and reimburse its creditors. While there are no readily available benchmarks that would help define what constitutes an "appropriate" level of public debt, large and continuously rising levels of indebtedness become increasingly difficult to manage and service. They also raise the risk that the government may default on its financial obligations and call into question the government's capacity to finance current and future program expenditures.

A government's ability to service its debt obligations can be evaluated through indicators that are known as "sustainability" measures. Sustainability(2) is defined here as the degree to which a government can maintain existing program expenditures and meet existing creditor obligations without increasing the debt burden on the economy. One such sustainability indicator measures the level of net debt supported by the federal government as a proportion of the country's Gross Domestic Product (GDP). This net debt-to-GDP ratio is commonly recognized as the most appropriate indicator of the debt burden, as it shows the relationship between the public debt and the taxpayers' ability to support and finance it. A stable net debt-to-GDP ratio indicates that, overall, government fiscal policies are "sustainable" in the sense that the economic growth rate is equal to the growth rate of the debt. A declining ratio means that debt-servicing charges absorb a smaller proportion of government revenues.

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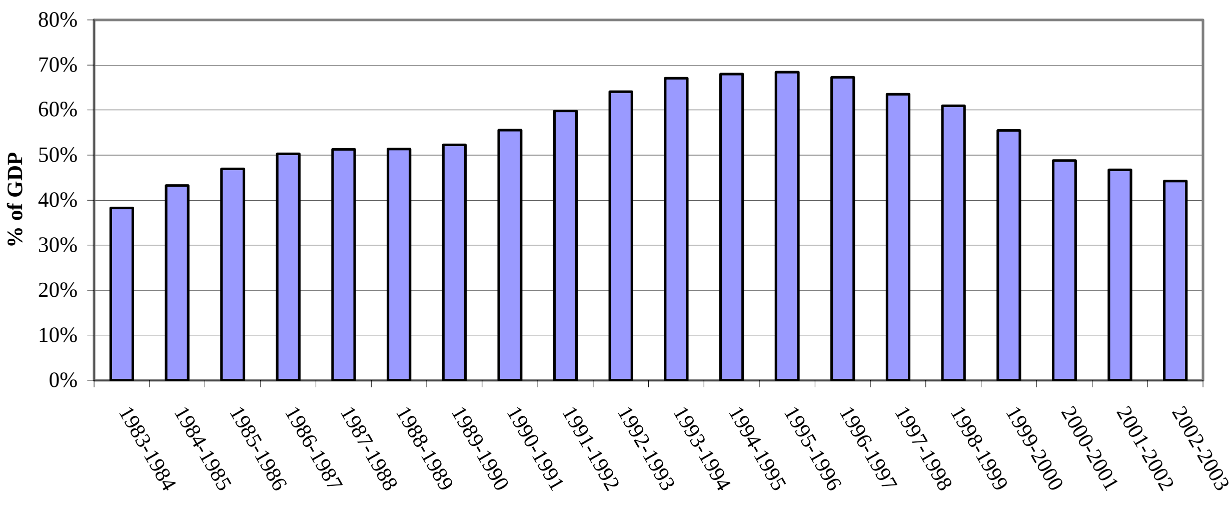
(2) *Ibid*., p. 6.

Conversely, a rising public debt-to-GDP ratio indicates an increasing debt burden borne by taxpayers. If the public debt-to-GDP ratio continues to grow, interest charges on the debt will likely also rise (both because the charges apply to a larger amount of debt and because the market may seek higher interest rates on new debt and debt rollovers, due to the fact that the debt burden is increasing). Debt-servicing charges thus progressively absorb more tax revenues, leaving fewer resources available to fund other program expenditures. At some point, the need to service the outstanding debt compels the government to cut program spending, or raise taxes, and/or maintain program spending at current levels and rely increasingly on deficit financing – which further adds to the growing public debt burden.

Governments that let debt accumulate over a long period of time risk eroding the living standards of their citizens as debt-servicing costs absorb a progressively larger share of the tax base, "crowding out" program spending. To reduce the debt-to-GDP ratio, either the government must begin to register a string of budget surpluses or, alternatively, economic growth must outpace the rise in the public debt.

The figures below present Public Accounts of Canada data from 1983 to 2003. For ease of comparison, the data have been revised to reflect the federal government's recent move to full-accrual accounting. Figure 1 presents federal public debt as a percentage of GDP.

Figure 1: Federal Debt as a Percentage of GDP



Source: Department of Finance, Fiscal Reference Tables (October 2003). All figures have been adjusted to reflect full-accrual accounting.

As shown in Figure 1, Canadian federal public debt rose throughout the 1980s and into the mid-1990s. It reached a plateau at around 51% of GDP during the late 1980s, when the federal government first managed to achieve operating surpluses (i.e., a budgetary balance where revenues exceed expenditures, excluding public debt charges). The net public debt resumed its upward progression in the first half of the 1990s when a recession caused federal budget deficits to increase. In response, the federal government introduced a number of measures aimed at controlling the growth in program spending. The net debt-to-GDP ratio peaked at 68.4% in 1995-1996, and then declined as the federal government began recording a succession of budget surpluses. In 2002-2003, after seven successive budget surpluses, the debt-to-GDP ratio stood at 44.2%, its lowest level since 1984-1985. As long as the federal government continues to record budget surpluses and the economy continues to grow, the ratio is expected to continue on its downward path.

Canada's economic growth in the second half of the 1990s explains to a large extent the improvement in overall federal government finances: rising tax revenues, declining interest rates, government spending restraint measures introduced in the 1994 and 1995 budgets, and other one-time factors affecting tax revenues, all contributed to return the federal government's overall budgetary balance to a surplus position and curb the growth of the federal public debt.

B. Budgetary Balance-to-GDP Ratio

Another measure of sustainability is the budgetary balance-to-GDP ratio, which measures the difference between revenues and total government expenses (program spending plus debt-servicing charges) expressed as a percentage of GDP. Figure 2 presents the federal budgetary balance(3) relative to GDP. The budgetary balance returned to a surplus position in 1997-1998, after 28 years of recording budget deficits.

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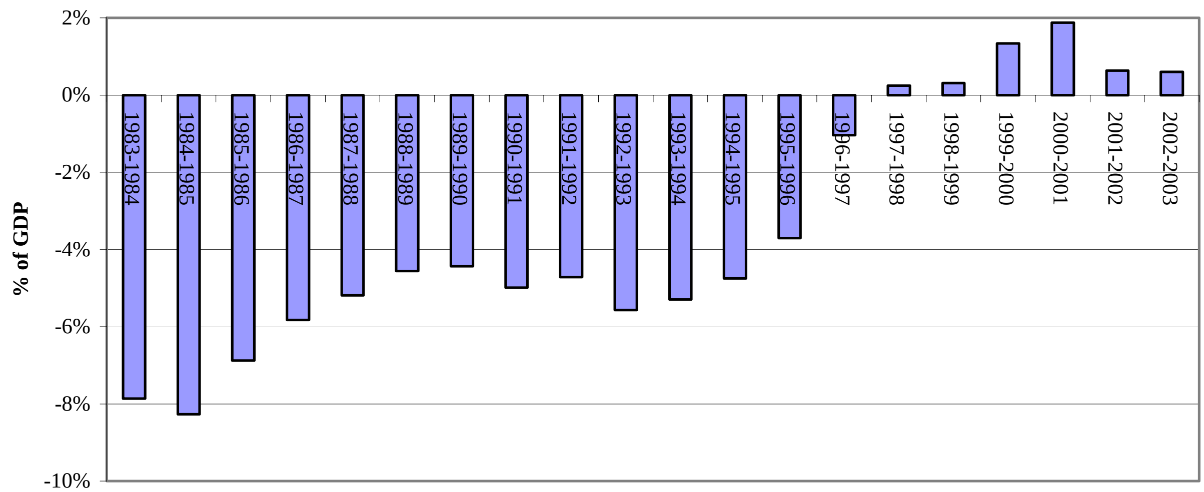
(3) The budgetary balance represents total government revenues minus program expenditures *and* public debt charges. The operating balance represents total government revenues minus program expenses, *excluding* public debt charges.

Figure 2: Federal Budgetary Balance as a Percentage of GDP



Source: Department of Finance, Fiscal Reference Tables (October 2003). All figures have been adjusted to reflect full-accrual accounting.

During most of the 1990s, federal government finances benefited from the combined effect of moderate interest rates, strong economic growth and slightly slower growth in program spending (as a result of expenditure control measures introduced in the 1993 and 1994 Budgets). These factors enabled the government to achieve a modest budget surplus in the 1997-1998 fiscal year and to continue recording budget surpluses through the end of the 1990s and the early 2000s. In 1999-2000 and 2000-2001, the surpluses amounted to $12.3 billion and $17.1 billion (1.9% of GDP), respectively. In 2001-2002 and 2002-2003, however, the government posted more modest budget surpluses of approximately $7.0 billion (0.6% of GDP). These reflected the slower economic growth that occurred during 2000-2001 and also, to a certain extent, some tax reduction measures introduced in the 2000 Budget.

FLEXIBILITY

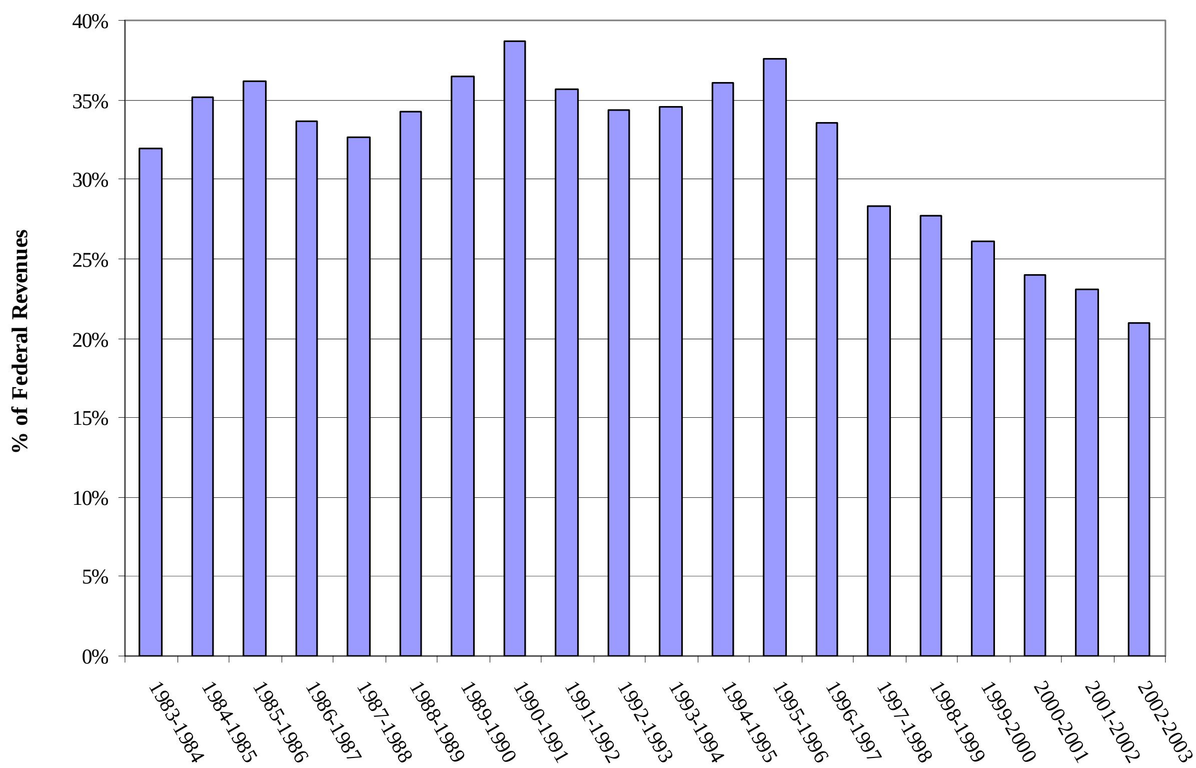
Flexibility indicators measure the degree by which a government can increase its financial resources in response to rising commitments, either by expanding its revenues or by increasing its borrowing (and thus increasing the size of the public debt).

A. Public Debt Charges as a Percentage of Federal Revenues

This indicator measures the size of public debt-servicing charges relative to total government revenues. Whenever a government has to borrow to finance its budget deficits, servicing the debt is the first priority in terms of available government revenues. To act otherwise would jeopardize the government's ability to borrow further on financial markets or to roll over existing debt. As public sector indebtedness rises, more tax revenues must be allocated to service the public debt charges, leaving less money available for discretionary program expenditures. Conversely, the lower the ratio of debt-servicing charges to revenues, the more money remains available, giving public administrators more flexibility in addressing other spending priorities.

Assuming stable interest rates, an increase in public debt-servicing charges over time indicates that the government is borrowing more on financial markets to fund program spending, rather than funding such spending through increased taxation revenues obtained by raising tax rates or expanding the tax base.

Figure 3: Public Debt Charges as a Percentage of Federal Revenues



Source: Department of Finance, Fiscal Reference Tables (October 2003). All figures have been adjusted to reflect full-accrual accounting.

Figure 3 presents net public debt charges as a percentage of total federal revenues. From 1983-1984 to 1996-1997, federal debt charges cycled in the 30-40% range of federal revenues; they declined steadily from 1997-1998 onwards as the government recorded a string of budget surpluses. In 2002-2003, these debt charges stood at 21 cents for each dollar of federal revenue, or about $37.3 billion – their lowest level since the late 1970s.

Overall changes in debt charges reflect both changes in interest rates and changes in the amount of debt that must be serviced. Canada's public debt charges actually began to decline, both in absolute terms and as a percentage of federal revenues, in 1995-1996, two years before the federal government began recording budget surpluses. That decline was initially due to the drop in interest rates that began in 1996. The average effective interest rate on the government's interest-bearing debt dropped from 8.0% in 1995-1996 to 7.5% in 1996-1997 and 7.3% in 1997-1998.(4)

CONCLUSION

As measured by some sustainability and flexibility indicators, Canada's federal public finances have improved considerably since the return to budgetary surpluses in 1997-1998. Those surpluses have helped to reverse the growth in the public debt. If the current trend continues, the decreasing debt levels will further reduce the costs of servicing the debt and thus give the government greater latitude in terms of budgetary choices and more flexibility in implementing fiscal policy.

The amount of federal public debt remains substantial, however. It would not take much to upset public finances – for example, a succession of budget deficits – and reverse the progress already achieved. Furthermore (although beyond the scope of this publication), various off-balance-sheet liabilities, such as unfunded public pension liabilities and other program obligations, must also be considered in order to properly evaluate the federal government's long-term financial sustainability. Demographic pressures are also playing a significant role in determining current and future solvency: as the proportion of the Canadian population aged 65 and over grows substantially (both in absolute numbers and relative to the overall population), the provision of health and related services to an aging population will put considerable strain on public finances as governments struggle with competing budget priorities and limited resources.

Despite these caveats, the federal government's financial situation has clearly improved in recent years. Many observers express cautious optimism that these trends will continue and that the federal government will sustain its efforts to remain solvent.

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(4) Department of Finance, *Annual Financial Report of the Government of Canada, Fiscal Year 1998-1999*, Ottawa, 1999.