

Budget Report 2010: The Long Road to Fiscal Balance

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Introduction Following the federal government's landmark stimulus plan of 2009, Budget 2010 steers the federal government back onto the straight and narrow road toward fiscal balance. Of course, given recent spending initiatives, the road to fiscal balance will be a challenging one—but the goal is within reach.

In fiscal year 2009–10, the federal government pumped over \$28 billion into the Canadian economy (not including an additional \$8.4 billion in partnered commitments from the provinces). Funding was widely distributed. A hefty amount went to propping up the beleaguered manufacturing sector. Employment Insurance rates were frozen and coverage was expanded. Strategic investments were made in infrastructure and capital development, and international competitiveness was addressed through continued successive reductions in the corporate income tax rate. By 2012, Canada will be enviably positioned as the G7 nation with the lowest tax levels on business investment. New commitments to reducing trade barriers are consistent with this vision, a natural continuation of the Advantage Canada plan (introduced by the federal government in 2006 with the goal of making Canada more competitive).

In the coming fiscal year, a further \$19 billion in federal stimulus will be unleashed as planned to help support the economy to recover from the 2008–09 recession. The massive spending will come at a substantial cost—a \$49.2 billion deficit in 2010–11. That, however, is an improvement from the September 2009 estimate of a \$55.9 shortfall; and The Conference Board of Canada estimates that there is considerable upside potential to the current economic forecast. Our forecast suggests that by 2013, nominal GDP could be as much as \$47 billion higher than projected in the budget, and that by 2014 federal tax revenues be as much as \$6.3 billion higher.

Perhaps the best news for Canadians is that a coherent exit strategy has been crafted, one that will enable the country to dig itself fully out of deficit by 2015–16. The diverse spending restraint initiatives presented in Budget 2010 will shrink the federal deficit to \$27.6 billion in 2011–12, and ultimately to zero in 2015–16. A freeze to government spending growth, tighter budgets for national defence and foreign assistance, and cuts to the lowest priority programs will generate savings that will grow to \$5.7 billion annually by 2015.

Deficit slaying notwithstanding, the country will still be saddled with a deep debt burden. By 2014–15, the federal debt will have surpassed \$622 billion—with annual public debt charges approaching \$41 billion. On a positive note, as a share of GDP, the federal debt burden will decline from a high of 35.4 per cent in 2010–11 to a touch under 32 per cent by 2015. Considering the major deficits accumulated by various provinces and the rising pressure on public health care from the aging population, the federal and provincial governments will need to exercise fiscal restraint in all areas.

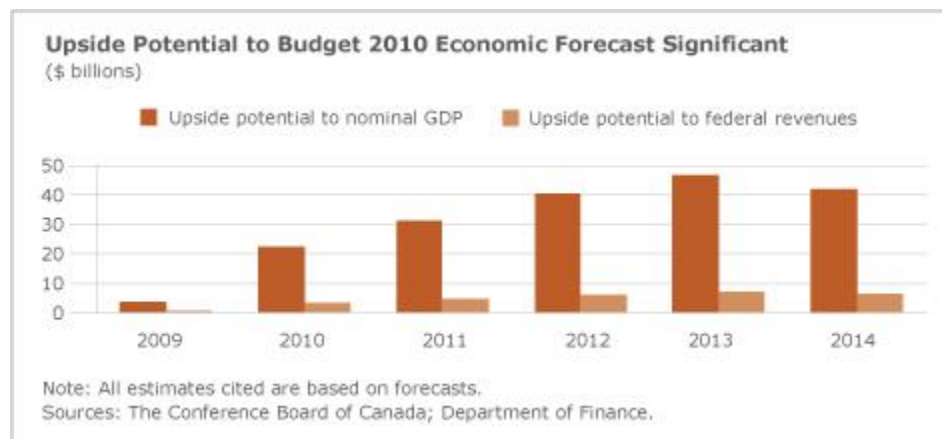
Upside Risk to Economic Outlook

The Department of Finance relies on a consensus of private sector forecasts to provide the economic indicators required in producing budgetary projections. The consensus outlook behind the current budget estimates is based on the third quarter of the National Income and Expenditure Accounts by Statistics Canada, and was updated as of December 18, 2009.

The Conference Board estimates that there is considerable upside potential to the economic forecast underpinning Budget 2010. After a year of economic duress, labour markets, industrial production, and consumer activity—both domestically and in the United States—are bouncing back, and that is exerting considerable upward pressure on the Canadian economy. The fourth-quarter Canadian Economic Accounts—which have not been included in the Department of Finance numbers—appear to validate the Conference Board's more optimistic view. The private sector consensus forecast of nominal GDP growth in the fourth quarter of 2009—a standard benchmark for the rate of growth of federal revenues—fell short of the actual growth of 9.8 per cent by more than 4 percentage points. The Conference Board's estimate for the same period, by contrast, was within half a percentage point of the actual growth.

Looking forward, the Conference Board's own forecast is stronger than that used in the federal budget. Our outlook calls for nominal GDP to grow by 6 per cent in 2010, compared with a projected 4.9 per cent in Budget 2010. The resulting difference between the forecasts is significant. Given our assumptions, an extra

\$22.4 billion in upside economic potential in terms of nominal GDP is possible this year alone, relative to the Budget 2010 estimates. The nominal GDP gap between Budget 2010 and our forecast peaks at \$46.7 billion in 2013. (See chart). Historically, the federal government has been able to capture roughly 15 per cent of nominal GDP as federal tax revenues. By 2014, this would generate an additional \$6.3 billion in federal revenues in excess of budgetary targets. In short, the deficit could be eliminated earlier than projected.



The sources of the Conference Board's stronger outlook are manifold. We anticipate a more pronounced U.S. recovery from 2010 to 2012, with our estimates of U.S. real GDP growth averaging 0.2 per cent per year above the Budget's consensus forecast. Moreover, commodity markets have begun to stabilize, and the natural resource sector will prove a key channel of federal government revenue growth. A swift recovery in production among a handful of export-driven industries, combined with oil prices surpassing \$115 per barrel by 2014, guides the Conference Board's stronger growth projections. If this pattern persists through the medium term, we would expect to see the output gap close by 2013. While not every sector will have recovered to their pre-recession output levels by then, the rate of convergence in the broad economy to potential will be sharp in the near term.

Fiscal Outlook

It will be a long and hard road back to fiscal balance. After posting the largest deficit on record in fiscal year 2009–10, the federal government will continue to shovel out the infrastructure spending this year. However, beginning in 2011–12, the federal government will change tack and attempt to tightly control spending across almost all categories of direct program spending. If it succeeds in maintaining such restraint, then—according to the budget—it will come just shy of balancing its books by the end of the forecast period in 2014–15. However, there is some upside potential to the government's numbers. As stated, based on Conference Board estimates of nominal economic growth (which is generally considered the largest measure of the tax base), federal revenues could be somewhat higher than predicted in this budget, allowing the government to balance its books in 2014–15—one year earlier than forecast.

That is not to say that balancing the books will be easy. The recent recession and the economic stimulus plan have taken a heavy toll on federal finances. By 2014–15, the federal debt will have risen to \$622 billion—an increase of \$158 billion from 2008–09, or more than \$9,000 in additional debt for every person who filed taxes in 2010.

According to the 2010 federal budget, the government will run a \$49.2 billion deficit in fiscal year 2010–11. The deficit will then improve substantially, falling to \$28.7 billion in fiscal year 2011–12 following the conclusion of the economic stimulus plan. As outlined in the budget, the federal government will be unable to balance its books over the forecast horizon. However, the deficit is expected to steadily improve, shrinking to just \$1.8 billion by 2014–15. To achieve this reduction without increasing taxes, the federal government plans to tightly control direct program spending. In fact, from 2013–14 to 2014–15, the federal government plans to limit direct program spending growth to just 1.3 per cent per year, well below expected inflation. This will not be an easy task, considering that the federal government has increased program spending by an average of 6.1 per cent annually over the last five years.

In order to hold federal spending growth to below inflation, the federal government has identified three main areas where it plans to make cuts. The defence budget is the largest category of direct program spending—consuming one-fifth of the total—and it was unlikely that it could continue unscathed. Spending on defence has been a priority for the government in recent years. Boosted by the requirements of the mission in Afghanistan, the overall defence budget has grown by an average of 8 per cent per year over the last five years. As part of the federal government's expenditure control targets, the National Defence budget will see its annual growth cut by \$0.5 billion in 2012–13 and again in 2013–14 following completion of the Afghanistan mission. In other words, although spending on defence will continue to increase, it will do so at a much slower rate.

The second main area to see spending restraint is the international assistance envelope. As part of the millennium goals, the federal government had committed to doubling international assistance by 2010–11. Although the federal government will follow through with this commitment, increasing foreign aid by 8 per cent in 2010–11, the international aid budget will then be capped at 2010–11 levels, saving \$438 million in 2011–12 and \$1.8 billion per year by 2014–15.

The federal government will also freeze departmental spending from fiscal year 2010–11 to 2012–13—which may prove to be the most challenging element of the budget to implement. Although employees will still see annual wage increases of 1.5 per cent in 2010–11, departments will not receive increases to fund these higher wages and will be required to slash spending elsewhere to cover these increases. In addition, the Treasury Board will continue its strategic review of all departments, eliminating programs it deems to be of low priority. Together, these measures are expected to save \$8 billion by fiscal year 2014–15.

Revenue Measures

Spending restraint is the order of the day in Budget 2010. As such, the bulk of new initiatives trim existing spending commitments to international assistance, national defence, and government administration. In addition to the fiscal housekeeping detailed here, the following significant measures have been adopted:

- An estimated \$353 million will be earmarked by 2014–15 to offset losses to employees who exercised company stock options and deferred tax obligations until the date of sale of the underlying shares.
- International trade will be fostered through the unilateral development of a tariff-free international trade zone for industrial manufacturing inputs and machinery and equipment, at an average annual cost of \$220 million between 2010 and 2012.

Expenditure Measures

A smattering of new targeted expenditure measures were unveiled in Budget 2010, falling primarily under the umbrella of fostering commercial competitiveness. While the scope of these initiatives is broad, new financing is quite small, averaging slightly over \$1 billion annually into the medium term. A number of research grants and research and development incentives are implemented under the theme of innovation, in addition to small-scale financing for regional economic development agencies. On the household side of the equation, additional funds are earmarked for training elite-level athletes, enhancing Northern access to healthful food, supporting the disabled and bolstering funding for the Canadian Security Intelligence Service and the Royal Canadian Mounted Police.

In addition to the freezing of departmental budgets, operating expenses at other federal organizations will be held flat over a similar time frame. Strategic reviews will trim 5 per cent of lower-priority federal programming over two years, resulting in net savings of nearly \$300 million in the medium term.

Economic Impact

Although Budget 2010 will not have an immediate impact on GDP growth in 2010–11, it does lay the groundwork for a more competitive business climate in future. The fiscal restraint announced in the budget will grow over time, with the bulk of the impacts accruing as of the second quarter of 2012. Even then, the impacts are small enough that they will not affect our outlook for real GDP growth.