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To Everything (Even Fiscal Policy) There Is a Time: A Time to Restrain and a Time to Spend

by

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Introduction

Can the federal government now decide to spend substantially more, or tax substantially less, without prejudicing its effort to reduce the burden of the federal debt? What happens if Ottawa relaxes its fiscal policy and then is confronted with a recession? Would a recession begin anew the accelerating increase in public debt that we have only so recently escaped? This paper seeks to shed some light on these and similar questions by estimating the impact on key fiscal indicators which would result from two alternative archetypical scenarios for spending and taxing in the forthcoming 1999 federal Budget.

This paper uses a fiscal model of the federal budget and its relation to the economy. The Caledon model was first developed to provide alternative estimates for the 1998 federal Budget in *To Pay or Not to Pay* [Mendelson 1998]. The specifications of the model will not be repeated here, as they are set out in detail in the 1998 paper. However, some new assumptions had to be made in updating the model. The following discussion reviews these new assumptions. It then presents the results of the two alternative Budget scenarios within two different economic contexts. Finally, the paper concludes with a brief discussion of the implications of these findings.

Updating the Caledon model

The Caledon model extrapolates from the current fiscal year, based upon assumptions about rates of inflation and economic growth and upon alternative spending and taxing scenarios. But the current fiscal year, 1998-99, does not end until March 31, 1999, so the actual spending and revenue for this fiscal year are not yet known. Table 1 sets out our 'best guess' for the current fiscal year. These estimates for 1998-99 are the base for the alternative scenarios outlined in this paper. Although Table 1 shows a large surplus of $9.7 billion for 1998-99, the implicit assumptions made to arrive at this result have been kept purposely conservative, so that, if anything, this is an underestimate of the current year's surplus.

First, spending on programs is estimated at $106.5 billion. This amount is $2 billion more than was budgeted for program spending when the 1998 Budget was tabled in February 1998. The $2 billion is a rough guess of over-expenditures made up of $0.5 billion more on transfers to persons, $1 billion more for transfers to other levels of government and $0.5 billion more for direct government spending.

The $0.5 billion additional transfers to persons is cautionary, reflecting higher old age pension expenditures reported to date in this fiscal year (offset by lower Employment Insurance payments). The $1 billion increase in transfers to other levels of government is meant to provide for probable higher than forecast Equalization payments, as a consequence of more dispersion among the growth rates of the provinces.

We have estimated direct program spending at $0.5 billion more than was allocated in the 1998 Budget. The $0.5 billion is meant to accommodate possible overspending reported to date. This may seem like an underestimate given that actual direct spending in 1997-98 was $3.7 billion higher than was planned for 1998-99, and there have not been any big cuts this year in direct government spending. However, program spending in 1997-98 included $5.5 billion of one-time spending – namely, the Canada Millennium Scholarship Foundation ($2.5 billion); a change

Table 1
Estimated 1998-99 fiscal results
compared to 1998 Budget and previous years

Expenditures ($billions)	Actual 1996-97	Actual 1998-99	1997-98 Budget	1998-99 Estimate
Transfers to persons	34.0	35.8	35.5	36.0
Transfers to governments	22.6	19.8	19.5	20.5
Direct program spending	48.2	53.2	49.5	50.0
Sub-total program spending	104.8	108.8	104.5	106.5
Public debt interest	45.0	40.9	43.5	41.2
Total spending	149.8	149.7	148.0	147.7
Revenue	140.9	153.2	151.0	157.3
(Deficit) surplus	($8.9)	3.5	3.0	9.7
Debt	583.2	579.7	583.2	570.0
GDP	807	855	892	889
Debt as % of GDP	72.3%	67.8%	65.4%	64.1%

Source: Canada [1998a, b and c].

in accounting for assistance to international financial institutions ($1.8 billion); compensation for Hepatitis C victims ($0.8 billion); and the Aboriginal Healing Strategy ($0.35 billion) [Canada 1998b: 49]. So $0.5 billion over-budget actually provides for a year-over-year increase in annual spending of about $2 billion – much higher than in any recent year.

This estimate of an additional $0.5 billion in direct program spending does not include any allowance for possible one-time allocations that the federal government may decide to add onto this year's expenditures before the fiscal year concludes. Such additions might include, for example, assistance for farmers. However, even if one-time additions are made, these do not have an impact on future years, so the basic scenarios are unaffected.

Interest payments on the public debt are calculated by assuming that the interest rates Ottawa pays in 1998-99 will be about a tenth of a percentage point higher on average than the previous year, reflecting slightly higher interest rates during part of this year.

Finally, nominal GDP is assumed to have grown by 4 percent and revenue is simply assumed to grow at the same rate as GDP, which is a standard working assumption. However, the revenue estimate has been reduced by a further $2 billion to account for Employment Insurance premium reductions and other tax cuts.

The unavoidable arithmetical consequence in 1998-99 of these purposefully conservative premises is the largest surplus in Canadian history, by several orders of magnitude. Debt as a percent of GDP, commonly called 'debt burden,' falls from 67.8 percent in 1997-98 to 64.1 percent in 1998-99. Debt burden stood at 74 percent in 1995-96, so Canada will have reduced its debt burden by 10 percentage points in just three fiscal years. *To Pay or Not to Pay* argued that the debt burden would fall rapidly, no matter what we did within a very large range. That paper estimated the debt burden at the end of 1998-99 would be about 65 percent in the base case if tax cuts and spending were kept to a minimum – one percentage point higher than what the debt burden turned out to be for that year. Revenues are turning out to be higher and debt financing charges somewhat lower than we estimated. Apparently we were insufficiently optimistic in our assumptions.

Scenario A - modest spending increases and tax cuts

Scenario A represents what we see as a good guess for the possible shape of the 1999 Budget. Scenario A includes $2 billion in tax reductions and $1 billion additional for each of direct program spending, transfers to persons and transfers to governments in 1999-2000. In 2000-01, we assume a further $1.5 billion in transfers to governments, another round of $1 billion each for transfers to persons and direct spending, and another $2.0 billion in tax cuts. We also assume that base spending will increase by at least the rate of inflation in 1999-00 and 2000-01. In total, these amounts should be adequate to accommodate all outstanding commitments as well as a $2.5 billion (over two years) increase in transfer payments to the provinces – and a little more besides.

For the eight years following 2000-01, we assume annual increases in spending of 2.5 percent on direct program spending, 2.0 percent on transfers to persons and 1.5 percent on transfers to governments, on top of annual increases equal to the rate of inflation. These assumptions keep direct government spending constant as a percentage of GDP and allow generous accommodation for ad hoc increases in the non-indexed transfer programs.

The economic assumptions are for long-term growth in real GDP of 2.5 percent, which is very modest by historical comparison, and inflation of 1.5 percent – again, a modest assumption.

What is Scenario A's long-term impact on debt burden? Detailed results of the model are shown in Appendix 1. In sum, debt burden would continue to fall rapidly.

The debt burden would fall from the actual 64.1 percent of GDP in 1998-99 to a projected 60.7 percent in 1999-00 and 56.9 percent in 2000-01. By 2008-09, the end of the ten-year period modelled, the debt burden would stand at about 20 percent – an extraordinarily low figure by both Canadian historical and international standards. (Because of accounting differences, Canada's 20 percent would probably be below 10 percent for purposes of international comparison). The surplus by 2008-09 would stand at $56 billion.

Such a huge surplus would never come about. In the real world, governments would decide long before the surplus reached the stellar heights of $56 billion to loosen the fiscal strings considerably. But the point is that, even with a modest spending and tax-cutting budget, Canada is on a firm downward path in debt burden.

Scenario B - extensive spending increases and tax cuts

In this scenario, we increase direct spending, transfers to persons and transfers to governments by $3 billion each in 1999-2000, and cut taxes by $3 billion. Furthermore, we do the same thing all over again in 2000-01. As in Scenario A, we adjust all three categories of spending by the rate of inflation in each of 1999-00 and 2000-01, and also assume the same ongoing increases in each of the three categories of spending.

The detailed results are provided in Appendix A. The debt burden still falls substantially, from 64.1 percent in 1989-99 to a projected 61.3 percent in 1999-2000 compared to 60.7 percent in Scenario A. In 2000-01, the debt burden falls to 58.7 percent as opposed to 56.9 percent in Scenario A. As in Scenario A, there is a large and growing surplus in every year for the next decade. By the end of the ten-year projection period, the debt burden also falls to historically low levels, 33 percent, with an equally politically unsustainable surplus of $31 billion. In short, despite the sizable amount of additional spending and large tax cuts, the debt burden remains on an extremely rapid downward path.

Of course, ours is a simplified fiscal model meant to give only ballpark estimates of the numbers involved. In reality, a sizable infusion of additional spending would have a positive impact on the rate of increase in GDP, likely increasing economic growth by at least a percentage point or more. Such growth would, in turn, boost tax revenue. More debatable is potential upward pressure on interest rates. Since the federal budget would remain in surplus, and the debt would remain clearly on a downward path, with more federal debt being retired every year, it is not likely that there would be any meaningful upward pressure on interest rates, despite the new spending and tax cuts. In total, were the economic dynamics to be included in the model, the likely consequence would be an even larger surplus – perhaps much larger – than is estimated by this model.

Effects of an economic downturn

We have made very conservative economic assumptions in both scenarios. Long-term economic growth is assumed to be 2.5 percent, while growth next year is assumed to be 2.0 percent. Inflation is assumed to be 1.5 percent over the whole projection period. But what happens if even these subdued projections of economic growth turn out to be overestimates, and the economy instead turns sharply downward?

Table 2 gives the results of two potential archetypical economic slowdowns. The first economic slowdown is a downturn to 1.0 percent growth per year for the next two years. The second is a recession, with two years running of economic decline at -1.0 percent each year. In both cases, we assume that the economy returns to modest growth of 2.5 percent after the two years. To make comparison simpler, we also assume that the inflation rate remains at 1.5 percent and the average interest rate on government debt at 7.0 percent.

Of course, keeping economic assumptions constant is not meant to be realistic. If the economy declined seriously, especially if there were negative growth, interest rates would doubtless decline sharply. This development would improve the fiscal results in the model.

But it is also likely that in any downturn we may have in the next few years, inflation will decline further or even turn negative (deflation). Lower inflation worsens fiscal results.

Thus these two effects tend to offset one another. For example, in Scenario B with a two-year slowdown and inflation at 0 percent but average interest rates falling to 5.0 percent, the long-term debt burden is almost unchanged from the 'standard' assumption made here of a 1.5 percent inflation rate and 7.0 percent interest rate. Given that the purpose of this model is to broadly ballpark fiscal scenarios, rather than to make predictions, we have left all the economic assumptions at the 'standard' throughout so as to facilitate comparisons of the fiscal scenarios.

Table 2
Effect of an economic slowdown on fiscal scenarios

	Base Case	Economic Downturn	Recession
Economic growth assumptions			
1999-00 GDP growth	2%	1%	-1%
2000-01 GDP growth	2.5%	1%	-1%
Scenario A			
1999-00 surplus/(deficit)	$12 billion	$10 billion	$7 billion
2000-01 surplus/(deficit)	$14 billion	$10 billion	$3 billion
2000-01 debt burden	56.9%	58.9%	62.3%
2008-09 debt burden	20.2%	25.3%	34.0%
Scenario B			
1999-00 surplus/(deficit)	$6 billion	$4 billion	$1 billion
2000-01 surplus/(deficit)	$2 billion	-$2 billion	-$9 billion
2000-01 debt burden	58.7%	60.8%	64.3%
2008-09 debt burden	33.0%	38.4%	47.6%

Source: Caledon Institute of Social Policy fiscal model

The results for Scenario A are that a surplus is maintained in every year in either case, whether there is just a slowing down of growth or a more serious recession. In either circumstance, the debt burden continues to fall, albeit a little less rapidly than if there were 2.5 percent real growth. But by 2008, debt burden is still down to very low levels.

In Scenario B, with a slowdown to 1 percent growth annually, there is one year of deficit in the decade, and by the end of the decade the debt is still down to 38.4 percent, a very respectable level by international standards. If there is a recession in Scenario B, a small deficit does reappear for a few years during and after the recession, but the rapid decline in debt burden then continues apace and by 2008-09 debt burden is down to 47.6 percent. This result is too high, although lower than the current debt burdens of AAA-rated G7 countries [Bank of Montreal 1999]. However, it takes only a few more years before the debt burden does decline to acceptable levels. Essentially, in the event of a serious recession, Scenario B only postpones for a few years the process of debt burden reduction; it does not reverse the process.

In short, fiscal doom and perdition do not await us if we decide to spend substantially more, or tax substantially less, than Ottawa is likely to do – even if there is a serious slowing down in the economy.

Implications

There is room to manoeuver in deciding on Canada's next Budget. This positive outcome is at least partly a result of the economic policy Ottawa has pursued since the Liberal government came to power.

In retrospect, it is easy to see that the Liberals found Canada's economic policy in a mess. The previous government's loose fiscal policy, combined with the Bank of Canada's tight monetary policy, greatly deepened and lengthened the 1990 recession, while the combination of big deficits with high interest rates led to accelerating debt service charges. Canada's debt burden climbed rapidly above 60 percent and showed every sign of continuing to scale new heights.

The Liberals reversed the Tories' policy instruments: The Chrétien government has combined a very tight fiscal policy with moderate monetary policy, bringing about lower interest rates and, as we have seen, putting the debt-to-GDP ratio onto a rapid and almost irreversible downward path.

So, the mess is in the process of being cleaned up, and credit should be given where it is due. But the question now is: What should be done next?

To a great extent, Ottawa's extraordinarily tight fiscal policy has been politically possible only because of the unparalleled continuing economic boom in the US. Were Canada an isolated island with a closed self-contained economy, Ottawa's tight fiscal policy would have resulted in such overwhelming dampening of consumer demand that a major recession and increasing unemployment would have quickly followed. Rather than slowly climbing out of the 1990 downturn, we would have fallen deeper in, and it is doubtful that any government could have survived the dire consequences for long.

In reality, we are not at all a self-contained economy; we are one of the foremost trading nations in the world, and our biggest trading partner by far is the US. By relying on the strength of the US economy to buoy up the export sector in Canada, we have been able to maintain the toughest fiscal policy in the Western world, while still seeing gradual growth in our economy. Put simply, American consumers have substituted for Canadian consumers.

The benefit of all of this has been a correction in our fiscal imbalance. The economic price we have paid is slower growth than we would have seen with a less restrictive fiscal policy.

The price was worth paying. Government finances had to be restored to health as a precondition of any successful social policies.

Our complaint is that the price seems to have been disproportionately borne by poor Canadians. Excessive cuts to so-called Employment Insurance, accompanied by no opportunity enhancing initiatives, the abolition of the Canada Assistance Plan, the elimination of Canada Mortgage and Housing's role in creating new social housing, and dozens of other smaller but still important cuts, have fallen mainly and heavily on lower-income families and individuals.

The numbers we have generated with our model have a clear message; namely, there is no need to continue indefinitely with such an extraordinarily tough fiscal policy. There is room to relax our fiscal stance, with spending and taxing decisions falling at least somewhere between Scenarios A and B.

The priority should be to use most of this fiscal room to help the poor and vulnerable. Assistance should come in the form both of increasing opportunity and redistributing income. Fiscal policy can be relaxed sufficiently over the next few years to raise the National Child Benefit to the $4,000 target level we have recommended elsewhere [Battle and Mendelson 1998] and thus make a real impact on the scourge of child poverty in Canada. There is also enough room to reduce income taxes, at least for low- and modest-income Canadians, to offset the regressive impact of 12 years of stealth taxes imposed through partial deindexation [Battle 1998]. Caledon has proposed additional areas for social reinvestment [Caledon Institute of Social Policy 1998].

In advocating a fiscal stance somewhere between Scenarios A and B, we are supporting a relaxation of the fiscal stance of the federal government, but not at all a spending spree. So long as the US economy is booming, we should take advantage of the propitious circumstances to continue rapidly reducing our debt burden. But there is a very large proviso in this advice: We also should be prepared to turn on a dime should the US economy falter. Should that happen, the immediate implementation of a much more generous fiscal policy would be called for, especially focussed on helping Canadians get through economic bad times. What this would really mean is postponing the extraordinary reductions in debt burden until the crisis is over.

If our governments are going to be able to turn on a dime, they must prepare contingency plans now, rather than waiting until the disaster is upon us. Remember the last round of federal infrastructure spending? It seemed like a good idea to renew public infrastructure when unemployment was highest and construction costs low, thereby creating a lasting benefit for future generations while helping to turn around the economy. However, the trouble with the last round of infrastructure programs was that by the time the dollars were actually being spent, the worst of the recession already had passed. Despite working as quickly as possible, it takes too long to plan such a program from scratch. Ottawa and the provinces ought to begin working together now to define a series of public projects that can be financed and started up almost immediately should there be a specific economic trigger (e.g., four consecutive months of downturn in leading economic indicators).

Under the new Canada Health and Social Transfer, the province and territories will bear the full brunt of increased welfare expenditures. But it is simply unrealistic to think that a major recession will occur without Ottawa getting re-involved in paying for some of the costs of provincial welfare. If there is a serious economic downturn, the federal government will be under intense pressure to bail out the hardest-hit provinces, and likely will accede eventually.

Rather than spending a few years dithering and then coming up with an ad hoc and poorly-designed policy that is not fair to all the provinces, why not set up a program right now? There are many simple and administratively feasible plans possible. For example, Ottawa could agree to pay 50 percent of the costs of welfare above a certain percentage of provincial GDP.

These and other measures should be considered now to plan for the contingency of another economic slowdown – a possibility that is all too likely to come to pass sometime in the next few years.

In short, Ottawa should now open the fiscal flood gates a little wider – not so wide as to threaten continued rapid reduction in debt burdens, but wide enough to address some of our most pressing social priorities. At the same time, the federal and provincial governments should jointly prepare now to take dramatic action if and when an economic storm front hits.

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