The Price of Prudence

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Michael Mendelson

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The Caledon Institute of Social Policy
1600 Scott Street, Suite 620
Ottawa, Ontario, Canada
K1Y 4N7
Phone: (613) 729-3340
Fax: (613) 729-3896
E-mail: caledon@caledoninst.org
Website: *www.caledoninst.org*

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The 1999 Economic and Fiscal Update's five-year projections

For the first time since coming to power, the Chrétien government's fall pre-Budget *Economic and Fiscal Update* includes a long-term fiscal projection [Department of Finance Canada 1999]. This new openness provides a common and realistic basis for a lively national dialogue about the priorities for the next Budget. The main issue, of course, is what to do with the fiscal surplus. And it is certainly an attractive surplus – totaling approximately $95 billion over the next five years, according to 1999's *Economic and Fiscal Update*.

In the 1999 *Update*, Ottawa proposes setting aside $28 billion of the $95 billion cumulative surplus as a 'prudent' measure. The ostensible rationale is to minimize the risk of any deficit, no matter how small. In practice however, all or almost all of the $28 billion would go to reduce the federal public debt.

But is this the best way to spend $28 billion? Instead of shaving a few more percentage points off an already declining debt burden, would it not be better to devote more resources to combatting poverty and homelessness, to give just one example of worthwhile spending? The allocation for fiscal prudence in the 1999 *Update* comes at a substantial cost: requiring Canada to forego meeting other critical public priorities. Is it worth it?

Table 1 shows the economic and fiscal projections presented in the 1999 *Update*. The projections are based on the average of four private sector forecasting firms' outlooks for the next five fiscal years. Overall, the resulting average forecast appears cautious but reasonable.

As can be seen in Table 1, government expenditures are the sum of *program spending* and *public debt interest* charges. *Program spending* includes transfers to other levels of government, transfers to people and direct federal programs. The 1999 *Update* projection maintains program spending at the same real level per capita by increasing it according to growth in population and inflation (i.e., this is the amount of funds it is assumed the government would need if there were no change in spending policy).

Public debt interest charges are determined by the total amount of public debt and the interest rate which the government pays on its outstanding borrowing. The underlying assumption on public debt interest is that government interest charges will remain a relatively constant average of 7.15 percent annually for the whole five-year period. This is a sensible assumption because much of the federal government's debt is in longer-term instruments, so short-term fluctuations in interest rates do not substantially affect public debt payments. Nor does it seem likely that Canada will experience any sharp declines in interest rates, as capacity utilization is high and central bankers are once again musing about inflation.

With respect to *revenue*, Table 1 assumes that the federal government's income will grow in line with the economy if there are changes in tax policies. For the first few years, revenue growth is projected to be less than economic growth to reflect tax reductions previously announced that are being phased in over the next two fiscal years.

Subtracting expenditures from revenue results in the projected annual surplus or deficit. In Table 1, this is called the *preliminary surplus/deficit*, since these projections assume no policy change.

Table 1
Fiscal projections from the 1999 *Economic and Fiscal Update*
(all dollar amounts in billions)

	Actual	Estimate	Forecast				
	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Program spending	$111	$112	$114	$118	$121	$124	$128
Public debt interest	$41	$42	$42	$41	$41	$40	$40
Total spending	$153	$153	$155	$159	$162	$164	$167
Revenue	$156	$158	$165	$173	$180	$188	$197
Preliminary surplus/deficit	$3	$5	$10	$14	$19	$24	$30
Contingency spending and/or tax cuts	$0	$2	$6	$9	$13	$18	$23
Final surplus/deficit	$3	$3	$4	$5	$6	$7	$7
Public debt	$577	$574	$570	$565	$559	$552	$545
Gross Domestic Product	$898	$945	$985	$1,027	$1,071	$1,126	$1,173
Debt as % of GDP	64.2%	60.7%	57.9%	55.0%	52.2%	49.1%	46.5%

Source: Department of Finance Canada 1999.

Contingency spending and/or tax cuts is the amount the 1999 *Update* proposes be treated 'for planning purposes' as available for spending or tax cuts. Ottawa proposes that $67 billion of the $95 billion cumulative total between 2000-01 and 2004-05 go toward new spending and/or tax cuts, leaving a *final surplus* of about $28 billion for the five-year period (totals on Table 1 do not add to the same amounts due to rounding). The 'final surplus' is the $28 billion allocation for fiscal prudence. Any unused portion of this allocation automatically is used to accelerate repayment of the public debt.

Public debt in Table 1 is the total amount of debt at the end of each year, given the assumptions set out above. *Gross Domestic Product* (GDP) is the forecast size of the economy based on the private sector forecasts. Finally, *debt as a percentage of GDP* is the amount of public debt compared to the size of the economy. Debt as a percentage of GDP (also called the debt-to-GDP ratio) is the usual way to measure debt burden: When the percentage goes up, our debt burden goes up, and when the percentage falls, our debt burden declines. If the plan in the 1999 *Update* were followed, 1999-2000's debt burden of 60.7 percent of GDP would shrink to 46.5 percent by the end of 2004-05, as can be seen in Table 1.

How much is really available for spending or tax cuts?

These days it is hard to find a wish – whether it is increased support for Olympic athletes or assistance for beleaguered hockey franchises – where the mere mention of looming federal surpluses is not taken as irrefutable evidence of Ottawa's capacity to make the wish come true.

There are, it almost seems, about 95 billion ways to spend $95 billion. Premiers want more for their provinces in federal transfer payments. Much of the business sector wants deep tax cuts, especially for higher-income Canadians, while others call instead for using most of the surplus to accelerate repayment of the debt. The social sector has sought a concerted attack on child poverty coupled with increased provision of services to meet family needs. For its part, the Caledon Institute has made its priorities clear: a balanced package of tax cuts for all (though favouring low- and middle-income families with children), a larger Canada Child Tax Benefit for the poor that also restores benefits for modest- and middle-income families, better parental leave benefits and a national child development fund that would help provinces and communities build a badly-needed early childhood education system [Battle and Mendelson 1999].

So despite the enormous size of the surplus, the federal government still faces difficult choices, just as it always has at Budget time, among several worthy and some less worthy (but perhaps politically attractive) alternatives. Indeed, the choices are probably *more* difficult now, because the possibility of funding has raised everyone's expectations. It is therefore at least as important as ever to know how much flexibility there is in the Budget.

Table 2
Option #1: use everything to pay down the debt
(all dollar amounts are in billions)

	2000-01	2001-02	2002-03	2003-04	2004-05
Contingency spending or tax cuts (i.e., funds available for spending or tax cuts)					
1999 *Update*	$6	$9	$13	$18	$23
Use all surplus for debt reduction	$0	$0	$0	$0	$0
Final deficit or surplus (surplus pays down the debt, deficit adds to it)					
1999 *Update*	$5	$6	$6	$7	$7
Use all surplus for debt reduction	$10	$14	$19	$24	$30
Debt as % of GDP (debt burden)					
1999 *Update*	57.9%	55.0%	52.2%	49.1%	46.5%
Use all surplus for debt reduction	57.3%	53.6%	49.7%	45.2%	40.8%
Change from *1999 Update* if all of the surplus is used for debt reduction					
Debt as % of GDP (% points)	-0.6	-1.4	-2.5	-3.9	-5.7
Spending	-$6	-$9	-$13	-$18	-$23

Source: Caledon projections based on Department of Finance Canada 1999.

As noted, according to the 1999 *Update*, of the projected $95 billion surplus over the next five years, $67 billion should be available for new spending or tax cuts, while $28 billion should be set aside for 'prudence.' The $28 billion normally would end up going towards accelerated repayment of the debt.

But alternative strategies are possible.

Following is a spectrum of five options. They range from the very fiscally conservative to the more fiscally expansive. The alternatives have been developed using the same assumptions as the 1999 *Update*.

option #1: use everything to pay down the debt

The most fiscally conservative strategy would be to use all of the surplus funds to pay down the debt, and none for new spending or tax cuts.

As can be seen in Table 2, using the whole surplus to accelerate repayment of the debt would mean a reduction of 5.7 percentage points in the overall debt burden at the end of five years, compared to the level of debt burden if the plan in the 1999 *Update* were followed. But there would be $67 billion less available for spending or tax cuts.

However, these projections are based on a straight 'arithmetic' application of new fiscal assumptions to the *Update*'s economic assumptions. In reality, using all the available money for debt reduction would precipitate a substantial slowdown in the economy. It is doubtful that monetary policy could compensate for such a shock to the economy; even the lowest interest rates imaginable could not offset the fiscal drag resulting from this strategy. Consequently, GDP growth would be much reduced from the *Update*'s economic assumptions, leading to much less revenue growth (and extra pressure on spending due to higher unemployment). Therefore, it is unlikely in this strategy that the additional 5.7 percentage points of debt reduction actually would be realized, and the gains in debt reduction would be much more modest.

option # 2: stick to the plan in the 1999 Update

This is the 'base case' presented in the 1999 *Update*, against which all the other alternatives are assessed. This option is noted here because it is the next alternative as we move from most to least fiscally conservative. The *Update* plan provides for $28 billion of the total $95 billion surplus to be set aside as a cushion to guard against untoward circumstances. Obviously, this approach is less fiscally conservative than using *all* the $95 billion for debt reduction, but it still would see a sizable portion (30 percent) of the surplus returned to the federal treasury.

The Department of Finance arrived at the amount of $28 billion by "continuing the practice of setting aside an annual $3-billion Contingency Reserve...[which] provides an extra measure of backup against adverse errors in the economic forecast." Then, on top of the $3 billion, it added "an extra degree of economic prudence to provide further assurance against falling back into a deficit" [Department of Finance Canada 1999: 73]. This additional prudence amounts to about $13 billion over the five-year period. The 1999 *Update* states that an extra degree of prudence had been embedded in federal Budgets in the past, and the only difference now is that it is being made explicit.

The main rationale given for $28 billion worth of prudence is to prevent any deficit

Table 3
Option #3: stick to the $3 billion prudence provision
(all dollar amounts in billions)

	2000-01	2001-02	2002-03	2003-04	2004-05
Contingency spending or tax cuts (i.e., funds available for spending or tax cuts)					
1999 *Update*	$6	$9	$13	$18	$23
The $3 billion provision	$7	$11	$16	$21	$27
Final deficit or surplus (surplus pays down the debt, deficit adds to it)					
1999 *Update*	$5	$6	$6	$7	$7
The $3 billion provision	$3	$3	$3	$3	$3
Debt as % of GDP (debt burden)					
1999 *Update*	57.9%	55.0%	52.2%	49.1%	46.5%
The $3 billion provision	58.0%	55.4%	52.9%	50.0%	47.8%
Change from 1999 *Update* if spent $3 billion provision on debt reduction					
Debt as % of GDP (% points)	0.2	0.4	0.7	0.9	1.3
Spending	$2	$3	$4	$4	$4

Source: Caledon projections based on Department of Finance Canada 1999.

recurring. But in the almost certain event that little or none of the $28 billion is needed for that purpose, it will be used to pay down the debt – as is reflected in the projections in Table 1. Therefore, another (unstated) rationale for Ottawa's fiscal plan is to accelerate reduction in the debt burden.

option # 3: stick to the original prudence factor of $3 billion

A slightly less fiscally conservative alternative than the 1999 *Update* would be to stick to the original explicit prudence factor of $3 billion a year. The results are shown in Table 3.

In this approach, there is $17 billion more for spending or tax cuts over the five-year period. Of the $95 billion surplus, $15 billion would be set aside and likely used to accelerate reduction of the debt. By 2004-05, the debt-to-GDP ratio would be 1.3 percentage points higher than in the 1999 *Update* plan, although still down almost 13 percentage points from the debt burden in the current fiscal year (1999-2000).

The economic differences between this alternative and the 1999 *Update* would be very small, with slightly higher growth and employment in this approach.

option #4: aim for a balanced budget

Moving along the spectrum, simply aiming for a balanced budget, where spending equals revenue, would be only slightly less fiscally conservative than setting aside $3 billion each year. The results are shown in Table 4.

In this balanced budget option, all of the $95 billion surplus could be used for spending or tax cuts, making $28 billion more available over the five-year period. In 2004-05, debt as a percentage of GDP would be 2.4 percentage points higher than in the 1999 *Update*, but there still would be a reduction in the debt burden from 1999-2000 of close to 12 percentage points.

This and the previous two options are similar fiscally 'moderate' alternatives. Each would see a steady reduction in debt burden and substantial sums available for new spending or tax cuts. However, while small, the differences among the three approaches are not necessarily negligible, especially between the balanced budget option and the 1999 *Update*.

The balanced budget strategy would provide for $28 billion of additional spending or tax cuts, so would be mildly more expansionary than the 1999 *Update*. At the very rough rule of thumb of 20,000 jobs for each $1 billion additional spending, the balanced budget option could generate about 560,000 more 'employment years' or

Table 4
Option #4: aim for a balanced budget
(all dollar amounts in billions)

	2000-01	2001-02	2002-03	2003-04	2004-05
Contingency spending or tax cuts (i.e., funds available for spending or tax cuts)					
1999 *Update*	$6	$9	$13	$18	$23
A balanced budget	$10	$14	$19	$24	$30
Final deficit or surplus (surplus pays down the debt, deficit adds to it)					
1999 *Update*	$4	$5	$6	$7	$7
A balanced budget	$0	$0	$0	$0	$0
Debt as % of GDP (debt burden)					
1999 *Update*	57.9%	55.0%	52.2%	49.1%	46.5%
A balanced budget	58.3%	55.9%	53.6%	51.0%	48.9%
Change from *1999 Update* with a balanced budget					
Debt as % of GDP (% points)	0.4	0.9	1.4	1.9	2.4
Spending	$4	$5	$6	$7	$7

Source: Caledon projections based on Department of Finance Canada 1999.

Table 5
Option #5: maintain the current debt burden
(all dollar amounts in billions)

	2000-01	2001-02	2002-03	2003-04	2004-05
Contingency spending or tax cuts (i.e., funds available for spending or tax cuts)					
1999 *Update*	$6	$9	$13	$18	$23
maintain the current debt burden	$34	$38	$46	$57	$59
Final deficit or surplus (surplus pays down the debt, deficit adds to it)					
1999 *Update*	$4	$5	$6	$7	$7
maintain the current debt burden	-$25	-$25	-$28	$33	-$29
Debt as % of GDP (debt burden)					
1999 *Update*	57.9%	55.0%	52.2%	49.1%	46.5%
maintain the current debt burden	60.7%	60.7%	60.7%	60.7%	60.7%
Change from *1999 Update* if the current debt burden is maintained					
Debt as % of GDP (% points)	2.9	5.7	8.5	11.6	14.2
Spending	$29	$30	$34	$40	$36

Source: Caledon projections based on Department of Finance Canada 1999.

an average of about 112,000 more people employed per year. With a labour force of about 16 million, this job creation would shave approximately 0.7 percentage points from the national unemployment rate compared to the 1999 *Update*. With over a million Canadians still unemployed, it is unlikely that the additional employment would put meaningful pressure on capacity utilization or wage rates.

There is another difference between the balanced budget option and the 1999 *Update* and, to a lesser extent, the $3 billion contingency fund alternative. In the balanced budget option, there is a strong possibility that the Budget would be in deficit by a small amount in at least a few of the years. No economic forecast is perfect and there is always some variation from plan. (Of course, if there is a major change in the economy, such as a worldwide recession, all bets are off and a new plan is needed under any of the options discussed here.) With a plan to hit 'zero,' the likelihood is to end up at least a small amount on one side or another of zero. However, contrary to current mythology, there is no significant economic or fiscal difference between being $400-$500 million in deficit and being $400-$500 million in surplus, especially if these variations from zero average out over five years.

Nevertheless, there is rather important symbolism in being on the plus side of the ledger.

Doubtless a great clamour would arise over any slippage into negative territory.

option #5: maintain the current debt burden for the next five years

Most Canadians likely think of a balanced budget as a 'neutral' fiscal position for government – 'neither a borrower nor a lender be.' However, in most sophisticated economic analyses, the 'neutral' fiscal position is judged to occur when the debt-to-GDP ratio is neither increasing nor decreasing. As we have seen, a balanced budget actually leads to a rapid and substantial decrease in the debt-to-GDP ratio. What new spending or tax cuts would be possible if the goal were to maintain the debt-to-GDP ratio at its current (1999-2000) level?

Table 5 shows a scenario in which debt burden is kept at a constant level for the next five years. There is an astonishing $234 billion available for spending and/or tax cuts over the five-year period. Of course, there would be some price to pay: The debt burden would be about 14 percentage points higher than in the 1999 *Update* plan.

The Table 5 projections are not realistic for this scenario because the additional spending would have a substantial impact on the economy, resulting in much higher growth, but with a significant risk of inflationary pressures and a consequent tightening of monetary policies through higher interest rates. The results could be a return to the bad old days when fiscal and monetary policy were pulling hard in opposite directions.

Therefore, this option should not be considered any more serious a contender than the other extreme alternative of using all the surplus to pay down the debt. Nevertheless, it is useful to understand this scenario, since it illustrates the outer limits of fiscal policy. It tells us that any amount less than about $234 billion of new spending or tax cuts over the next five years will result in an improving debt burden, everything else being equal.

Choosing among the options

In economic and fiscal terms, there is little difference among the three moderate options in the middle (i.e., the plan in the 1999 *Update*, staying with the original $3 billion prudence factor, a balanced budget). The debt burden targets of the 'toughest' among the moderate fiscal policies, the 1999 *Update* plan, are easily achieved and more by either of the other two moderate options in the following year. In fact, if there were a means to measure debt burden in any given month, then we could think of just a few months as separating each of these alternatives.

However, there are significant differences in the amounts available for new spending and/or tax cuts available under each of the three moderate alternatives. If a $3 billion contingency fund were maintained, with no additional prudence factor, there would be $2 billion additional, over and above the $6 billion in the 1999 *Update*, available in 2000-01 – rising to $4 billion, over and above the $23 billion in the 1999 *Update*, by the end of the five-year period. For the balanced budget option, there would be $4 billion additional available in the first year, rising by 2004-05 to $7 billion more than the plan in the *Update*.

These are real differences. For example, the total cost of the Caledon tax cut and social

investment proposal when fully phased in would be about $9 billion. A national child care system likely could be implemented for the amount of difference between the balanced budget option and the plan in the 1999 *Update*. Or, to take a rather different example, either of these moderate alternatives to the 1999 *Update* would accommodate the cost of fully indexing the income tax system over the five-year period.

According to strictly rational criteria, the potential benefits that can be obtained from the additional spending or tax cuts available, under either the $3 billion contingency option or the balanced budget option, far outweigh the benefit of achieving a very marginally lower debt burden just a little faster. However, the criteria used by policy-makers are not strictly rational.

The potential for a deficit reappearing at some point in the five-year period is higher with a smaller contingency fund. The risks associated with a provision for a $3 billion contingency fund remain small. But with a balanced budget plan, there will be some years in which the Budget will be some hundreds of millions of dollars on either side of zero – i.e., there will be a deficit in some years.

However, there are no rational grounds for concern over such deficits. While a deficit may have symbolic importance, a small deficit caused by slight variation from forecast in a balanced budget plan has no actual economic or fiscal importance. As we have seen in the 'maintain the current debt-to-GDP ratio' alternative, there is a huge amount of room before we need to worry about the debt burden beginning to grow again. A balanced budget plan remains firmly within debt burden reduction territory.

Conclusion

Federal fiscal policy should plan for a balanced budget, rather than build in an additional 'prudence factor' of $28 billion over the five-year period as suggested in the 1999 *Economic and Fiscal Update*. Aiming for a balanced budget is a fiscally sensible approach; indeed, it is even fiscally conservative, resulting in a rapidly falling debt-to-GDP ratio, with a reduction between 1999-2000 and 2004-05 of 12 percentage points. There is nothing radical about advocating a balanced budget.

In choosing between the options of a large prudence factor as in the *Update* and a balanced budget as advocated here, we need to ask ourselves a simple question: Under which alternative would Canada be better off in five years? Would we be better off with a debt-to-GDP ratio 2.4 percentage points lower? Or would be better off if we did more to combat child poverty or provided universal early childhood education or reindexed the tax system? If we line up priorities for $28 billion in the next five years using the simple criterion of what would make Canadians better off in April 2005, there are at least a dozen excellent potential candidates for the money before we get down the list to the alternative 'reduce the debt burden by an additional 2.4 percentage points.'

The balanced budget plan implies that there is a risk, indeed a near certainty, of some deficit appearing at least once or twice in the five-year period. But a small deficit with a rapidly falling debt burden is of no material significance: Its only importance is political. The political importance of a deficit, in turn, seems to rest largely on the media's take. No doubt Ottawa

could figure out a communications strategy whereby it explained to the media ahead of time that it will balance a budget over five years and may have some small deficits (small relative to the size of the federal budget), which will average out with small surpluses over that time period.

Sacrificing the best interests of Canadians by setting aside a large sum of money – which could be put to much better use – is too high a price to pay for political protection from a purely symbolic problem.

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