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The Alternative Federal Budget 2007 Economic and Fiscal Update

Can Ottawa Afford More Conservative Government Promises?

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Introduction
Can They Pay for What They Say?

In its effort to gain popularity — and perhaps even a majority in the next election — the Harper government must decide what new promises it will make. Since the Conservatives may have the opportunity for only one more budget before the election, they must design the 2007 federal Budget as a document on which they can fight an election campaign.

Indications already exist that the Conservatives plan further tax cuts. As Finance Minister Flaherty recently indicated to reporters:

> "We would like to reduce all taxes, and I am going to talk more about that in the fall economic update and our overall economic strategy. Then we'll make the choices for our next federal budget"[1]

But can the Conservatives afford another round of substantial tax cuts? The Finance Minister's upcoming *Economic and Fiscal Update* will signal how much money the Harper government expects to have at its disposal in its 2007 Budget.

The *Alternative Federal Budget (AFB) Economic and Fiscal Update* contains our current forecast of the government's future fiscal position. We intend this report to be informative for Canadians who wish to assess how the Conservative government will pay for the promises it has already made, as well as any new promises that may be forthcoming in the period before the next election.

The report is divided into four sections:

- **Section 1** provides some context to the discussion of whether Ottawa can anticipate large budget surpluses in the future.
- **Section 2** presents the current macroeconomic outlook for the Canadian economy.
- **Section 3** sets out our AFB projections of the revenues, expenses, and budgetary surplus of the federal government for the fiscal years 2006–07 through 2010–11.
- **Section 4** provides our assessment of how the Conservative government may try to "pay for what they say" in light of the AFB forecast.

Noteworthy assumptions or methodological issues are highlighted in the relevant section.

1 Can The Conservatives Count On More Windfall Budget Surpluses?

If the Conservative government is going to make expensive new promises, it needs to have forthcoming budget surpluses that are large enough to pay for these promises (assuming that the federal government will neither raise taxes nor go into deficit).

After a long string of large "surprise" budget surpluses, Canadians have become accustomed to a federal government that can somehow discover extra cash should the need arise. The persistence of these surprise surpluses — despite a variety of negative economic events over recent years — creates a climate of complacency. The perception that large budget surpluses is a foregone conclusion may foster the assumption that any and all tax cuts or spending measures are likely affordable.

The anatomy of a "surprise" budget surplus

Since the Chrétien-Martin era, Canadians have become accustomed to "surprise" budget surpluses. These were largely engineered by the Finance Department's systematic underestimation of revenue projections and overestimation of expenditure projections. This perennial "padding" that the Finance Department incorporated into its budget surplus projections allowed the Finance Minister the flexibility to pay for new spending or tax measures out of these "surprise" budget surpluses.

AFB fiscal forecasts have long been more accurate than the government's — in large part because the AFB has been successful in discerning the padding that misrepresents the true state of Ottawa's finances.

What are the Conservative government's current surplus projections?

The Conservative government's own assessment of its fiscal room in this current 2006–07 fiscal year indicates that they expect forthcoming budget surpluses to be quite modest.

The 2006 Budget indicated that new tax cuts would cost $9.9 billion and net new spending measures would cost another $4.4 billion in 2006–07 alone. In addition, the Conservatives promised $3 billion in debt repayment, making a total of $17.3 billion required to fund the Conservative agenda in this year alone. Since the Fi-

TABLE 1 Forecast and Actual Federal Budget Balances, 1999–2000 through 2005–06* (billions of dollars)

	Official Budget Target**	AFB Estimate†	Actual
1999–00	3.0	16.0	12.7
2000–01	3.0	15.5	18.1
2001–02	1.5	8.5	8.9
2002–03	3.0	6.7	7.0
2003–04	1.8	8.3	9.1
2004–05	3.0	9.2	1.5‡
2005–06	8.0	11.4	13.2
Total	**23.3**	**75.6**	**70.5**

* Prior to fiscal year 2002–03, estimates were not made in terms that reflected full accrual accounting measures. As of October 2003, the government has provided fiscal reference tables that restate previous numbers in full accrual terms. However, Table 1 presents the pre-accrual numbers for years prior to 2002–03 in order to compare the government's estimates with AFB estimates for those years. For years 2002/03 and beyond, all numbers are expressed in full accrual terms.

** Equal to balance of "budget for planning purposes", excluding contingency reserve fund, from each annual federal budget.

† Estimates of AFB status-quo federal surplus reported in Vital Measures: Alternative Federal Budget 1999 (February 1999); Reality Check: An Alternative Economic Update (October 2000); Alternative Federal Budget Economic and Fiscal Statement (December 2001); The Cure for the Common Budget (February 2003); Rebuilding the Foundations (March 2004), It's Time (February 2005) and CCPA's Federal Fiscal Corecasting Report prepared for Standing Committee on Finance, House of Commons (October 2005) respectively.

‡ In 2004/05 the Federal government disclosed expenditures of $6.5 billion after the fiscal year end . These expenditures, related to Atomic Energy of Canada and Offshore Revenue Agreements, created a surprising reduction in the 2005/06 surplus.

TABLE 2 Federal Budget Projections (billions of dollars)

	BUDGET 2006		TD BANK		
	2006–07	**2007–08**	**2008–09**	**2009–10**	**2010–11**
Budgetary revenues	227.2	235.8	244.0	253.4	264.8
Program expenses	188.8	196.5	204.5	214.0	222.5
Debt Paydown	3.0	3.0	3.0	3.0	3.0
Public debt charges	34.8	34.8	34.6	34.4	34.2
Budgetary surplus or deficit (-)	0.6	1.4	1.9	2.0	5.1

SOURCE Budget 2006 (for 2006–07 to 2007–08 projections), TD Economics (thereafter).

nance Department estimated that the government had $17.8 billion in available fiscal room for 2006–07, Budget 2006 indicated that there would be a remaining budget surplus of a scant $0.6 billion left in 2006–07[2].

Budget 2006 indicated that a similar pattern of low projected budget surpluses continued in 2007–08. Unfortunately, the Conservatives have unhelpfully abandoned the previous government's presentation of five-year projections, which makes it difficult to judge the future affordability of any tax cuts or spending increases that have budgetary implications beyond 2007–08.

Using the Finance Department's own implicit assumptions, the TD Bank has extended the official forecast to 2012–13 in their report titled "The Status Quo Federal Fiscal Outlook: Not Much Room Here".[3] Table 2 presents the government's own budget surplus estimates for 2006–07 to 2007–08, and the TD Bank projections thereafter.

Certainly the budget-surplus forecasts depicted in Table 2 suggest that there is not much cash available to finance new tax cuts or spending measures.

But aren't the Conservatives already showing high budget surpluses?

The federal government recently reported a $13.2 billion budget surplus for 2005–06. This news may have created the impression that large budget surpluses are continuing.

We caution readers against using the 2005–06 results as an indication of future budget surpluses. The last surplus was accumulated largely under the previous Liberal government. Since that time, the Conservative government has put in place a larger range of tax cuts, as well as some new spending. These measures will deplete budget surpluses far into the future.

Similarly, the preliminary data recently released in the Fiscal Monitor should be interpreted with caution. The preliminary results from April to September 2006 indicate a budget surplus of $5.3 billion. Perhaps one might jump to the conclusion that full year surplus will be $10.6 billion (the preliminary six month surplus doubled).

This would indeed be a hasty conclusion. The tax and spending measures introduced in Budget 2006 are not yet fully reflected in the Fiscal Monitor results. For example, the GST cut (projected by the Finance Department to cost $3.5 billion this fiscal year) has only been in place since the beginning of July, thus the impact of this reduction in revenues is still being registered in the data. Secondly, the Fiscal Monitor results are preliminary — they can be adjusted substantially after the books are closed on the fiscal year. For example, in the Fiscal Monitor for March 2005 indicated a preliminary surplus of $9.8 billion for the full 12 months of the 2004–05 fiscal year. Year-end adjustments made after the fiscal year ended reduced that surplus to $1.5 billion.

Contingency reserves and the "surprise" budget surplus

Another factor that repeatedly contributed to large "surprise" budget surpluses was the incorporation of a $3 billion Contingency Reserve (as well as reserves for economic prudence) in the federal budget. These reserves were typically not needed, so the Contingency Reserve had the effect of boosting the budget surplus by a further $3 billion. Since any budget surplus remaining after fiscal year-end is used for debt repayment, the $3 billion Contingency Reserve became a de facto debt repayment fund.

The Conservative government has stopped the previous government's use of Contingency and Economic Prudence reserves. Thus, the budget surplus estimates now provided by the Finance Department are intended to be indicative of the full fiscal room available.

However, the Conservatives did promise in their platform, (and implemented this promise for the fiscal years covered in Budget 2006) that they would allocate $3 billion for debt repayment per year.

Does the $3 billion debt repayment fund play the same role as the previous Contingency Reserve? We don't think so.

In the past, the AFB considered the Contingency Reserve to be as part of the total anticipated surplus. Like other money in the budget surplus, the Contingency Reserve was available to fund new tax, spending or debt repayment measures.

While the Contingency Reserve might have been used for any purpose, funds earmarked for debt repayment are to be used only for debt repayment.

In this respect, we disagree with media coverage that has exagerated the forthcoming budget surpluses by including the $ 3 billion in debt repayment. For example, journalists widely reported that the 2006 budget projected a budget surplus of $3.6 billion in 2006–07. We disagree. The 2006 Budget projected a budget surplus of $600 million, and an additional $3 billion was set aside for debt repayment.

Are we likely to have large forthcoming federal budget surpluses?

One avenue of boosting surprises budget surpluses — the Contingency and Economic Prudence funds — are now discontinued. Thus budget surpluses will be larger than those depicted in official projections if

1. Macroeconomic conditions have improved since the time of the Budget 2006.
2. Government revenues are higher than anticipated in the Budget 2006.
3. Program expenses are less than projected in the Budget 2006.
4. Debt service costs are lower than projected in the Budget 2006.

2 Macroeconomic Forecast

The AFB macroeconomic forecast is generated by consulting several publicly-available forecasts.[4] Most of these forecasts extend until the end of 2007, though some extend to 2008. However, we wish to prepare a fiscal forecast that stretches until 2010–11, both because a long-term forecast is required to assess the affordability of new measures, and because the Conservatives' election platform promised measures that extend until 2010–11.

Table 3 presents our forecast of key macroeconomic indicators. Until 2008, it reflects the consensus of the forecasts we consulted. Thereafter, we hold all macroeconomic variables constant (unless otherwise stated). Table 4 compares our AFB consensus macroeconomic forecast with the macroeconomic assumptions made in both the May 2006 Budget and the November 2005 Economic and Fiscal Update.

Real GDP growth is forecasted at 2.8% for 2006 and 2.5% for 2007. Forecasted real economic growth is now lower by 0.2% for both 2006 and 2007, compared to what was forecast in the May 2006 federal Budget. The increased value

TABLE 3 **Consensus Macroeconomic Forecast Prepared by CCPA** (Percent)

	2005	2006	2007	2008	2009–2011
Real GDP growth	2.9	2.8	2.5	3	2.8
GDP inflation	3.2	2.1	2.1	1.9	1.9
Nominal GDP growth	6.2	5.0	4.7	5.0	4.8
3 month treasury bill rate	3.4	4.2	3.9	4.3	4.3
10 year government bond rate	4.0	4.0	4.1	4.9	4.9
Unemployment rate	6.8	6.4	6.5	6.4	6.4
Employment growth	1.4	1.9	1.1	1.2	1.2
Pre-tax corporate profits growth	10.6	6.0	4.0	4.0	4.0
US real GDP growth	3.2	3.3	2.4	3.2	n/a
Exchange rate (CD/USD)	0.85	0.88	0.88	0.89	0.89

TABLE 4 Comparison of Current CCPA Consensus Forecast with May 2006 Federal Budget and November 2005 Economic and Fiscal Update (Percent)

REAL GDP GROWTH	2005	2006	2007
November EFU	2.8	2.9	3.1
May 2006 Budget	2.9	3.0	2.7
Current CCPA consensus	2.9	2.8	2.5
GDP INFLATION			
November EFU	2.4	2.2	1.6
May 2006 Budget	3.1	2.9	1.8
Current CCPA consensus	3.2	2.1	2.1
NOMINAL GDP GROWTH			
November EFU	5.3	5.2	4.7
May 2006 Budget	6.1	6.0	4.6
Current CCPA consensus	6.2	5.0	4.7
3 MONTH TREASURY BILL RATE			
November EFU	2.7	3.4	4.1
May 2006 Budget	2.7	4.0	4.1
Current CCPA consensus	3.4	4.2	3.9
10 YEAR GOVERNMENT BOND RATE			
November EFU	4.0	4.4	5.1
May 2006 Budget	4.1	4.4	4.5
Current CCPA consensus	4.0	4.0	4.1
UNEMPLOYMENT RATE			
November EFU	6.8	6.8	6.8
May 2006 Budget	6.8	6.6	6.6
Current CCPA consensus	6.8	6.4	6.5
EMPLOYMENT GROWTH			
November EFU	1.3	1.3	1.4
May 2006 Budget	1.4	1.5	1.2
Current CCPA consensus	1.4	1.9	1.1
US REAL GDP GROWTH			
November EFU	3.5	3.3	3.2
May 2006 Budget	3.5	3.4	3.0
Current CCPA consensus	3.2	3.3	2.4

of the Canadian dollar (vis-à-vis the U.S. dollar) has led to a deterioration of the trade balance, which has in turn contributed to a slowdown in the Canadian economy. In addition, there is a more pessimistic outlook for the growth of the U.S. economy in 2007, which is largely based on a downturn in the U.S. real estate sector. This slowdown in U.S. growth has contributed to a reduction of the Canadian real GDP forecasts for that year. Likewise, the growth in pre-tax corporate profitabilty is projected to decline to 4% in 2007, down steadily from 10.6% in 2005.

The forecast for nominal GDP growth for 2006 of 5%, is much lower than that which was assumed in the May 2006 Budget. This is partly a reflection of the lower expectations for real GDP growth. However, we also forecast that the GDP deflator in 2006 will be lower than what was expected in the May 2006 Budget, in part because of lower inflationary expectations for production prices in light of the recent downturn in the prices of oil and other commodities. We forecast that inflationary pressures on production prices will resume somewhat in 2007, so despite lower real growth expectations, we forecast a nominal GDP growth of 4.7% for that year. This is comparable to what was assumed in the May 2006 Budget.

Prices of consumer goods are expected by the Bank of Canada to increase faster than what was previously projected. According to the Bank, this is an indication that the economy currently operates above its productive capacity level. Combined with fairly strong domestic demand, this relative overheating of the economy has contributed to a recent increase in different indicators of consumer prices, such as the Consumer Price Index (CPI), over and above what had been previously expected.

In the longer term, we adopt the Bank of Canada's assessment that the Canadian economy will go back to its potential rate of growth in real GDP, which the Bank of Canada believes is 2.8%.[5] In doing this, we adopt the Bank's assumption that the U.S. economy will rebound by the end of 2007. Following the hypothesis of a "soft-landing" in the US economy towards the end of 2007, with a renewed expansion during 2008, we adopt the optimistic stance of the few private forecasts whose estimates go as far as 2008 and predict a real GDP growth of 3.0%, slightly above potential, for 2008. However, there are signs pointing to a persistence of the downward trend in Canadian growth, some of which we mention below. Regarding the GDP deflator in the longer term, we simply adopt TD Bank's projection of 1.9% in 2008 and extend it forward.

Long term interest rates are forecast to be lower than was foreseen at the time of the 2006 Budget. Our forecast stands at 4% in 2006, and 4.1% for 2007, down 0.4% from the previous forecast. Short-term interest rates, on the other hand, are expected to be roughly consistent with what had been assumed in the May 2006 budget, at 4.2% for 2006 and 3.9% in 2007. We expect both short and long-term interest rates to increase in 2008, reaching 4.3% and 4.9% respectively by the end of the year.

Further downsides to the macroeconomic forecast

In addition to the "bad news" already factored into our macroeconomic forecast, there are other sources of potential "bad news" ahead. While it is impossible to assess the likelihood that any (or all) of these difficulties will materialize, readers should be aware that it is possible that these concerns may prove to be more troublesome than we have assumed in our forecast.

The macroeconomic forecast presented here is based on a relatively "soft-landing" for the U.S. economy, but there are downside risks that may create a more pessimistic picture. The impact of the turbulence experienced by the housing sector may spread into other sectors, thereby generating a deeper slowdown than has been anticipated. Moreover, despite 17 consecutive quarter-point increases in the interest rate, the U.S. inflation rate is still above the "comfort" level of the Federal Reserve. This implies that the margin of manoeuvre for the Federal Reserve, should the economic situation prompt it to intervene, may be low.[6]

Moreover, there are also signs that the housing sector might be slowing down in Canada as well, which could in turn lead to a deeper and more durable downturn in the rest of the economy than what we have forecast.

Some analysts also contend that Canada may be suffering from a "Dutch disease" phenomenon, whereby the boom in one sector of the economy contributes to dysfunction in other sectors. A rapid rise in the prices of an important export — energy — has increased the exchage rate of the Canadian dollar, thus decreasing the competitiveness of other sectors, notably manufacturing. Proponents of this viewpoint worry that the current situation could be damaging to Canadian GDP growth in the medium and long-run, particularly if oil and other commodity prices were to rebound.

While not wishing to arouse excessive pessimism, we do acknowledge the possibility of a deeper downturn than we have forecast.

3 The Federal Fiscal Forecast

The AFB federal fiscal forecast presents the outlook for federal finances on a "status-quo" basis, in the sense that our projections assume that the policies articulated in the government's 2006 Budget will prevail for the length of our forecasting period. We make no allowance for any revenues or expenditures other than those that have been explicitly stated in the 2006 Budget or elsewhere. Thus we examine existing patterns discernible in government revenues, expenditures and debt service charges, and project these patterns forward, subject to forecasted macroeconomic conditions and any explicit policy changes enacted to-date by the government.

A note concerning a change in the government's presentation of fiscal information

The government changed its approach to reporting revenues and expenditures. The previous government presented revenue and expenditures on a "net" basis. In this approach, revenue earned by federal government agencies in the normal course of their operations was offset against their expenditures, for budget purposes. Revenue and expenditures are now presented on a "gross" basis. All government revenue — whatever the source — is reported as revenue; all government expenditure — whether offset by operating earnings or not — is reported as expenditure. To ensure comparability with official forecasts, the AFB projections follow the government's new process of presenting revenues and expenditures on a gross basis.

The presentation of revenues and expenditure on a gross basis has the effect of increasing both revenues and expenditures by an equal amount, thus leaving overall budget surplus figures unchanged. However, important ratios, such as revenue/GDP and program spending/GDP, are now higher because the revenues and expenditures are expressed in gross terms.

The switch from net to gross reporting may cause some confusion, because important ratios in the government's 2006 Budget are not directly comparable to ratios presented in previous years. Appendix A provides a comparison between these old and new formats, so the reader can see the difference in the gross and net measures for revenue/GDP and program spending/GDP for the period 1983–84 to 2005–06.

Revenue projections

The federal government recently announced measures dealing with income trusts. The AFB has long demanded that the government take action to close this gratuitous tax loophole which was threatening to make a mockery of the corporate income tax system. However, these measures taken to close the tax loophole will be costly in terms of both corporate and personal income tax revenues, in ways we detail below. These costs are over and above those of the increase in the dividend tax credit, that was previously implemented but failed to deal with income trusts.

Given that the costing of these recently announced measures is very debatable, throughout our discussion of income trusts we have elected to use the federal government own costing.

On the corporate income tax (CIT) side, the government has indicated that revenues will increase (although not dramatically) when the measures to tax income trusts become operative in 2010. As we show below, however, this increase should be more than outweighed by a further cut to the corporate tax rate of 0.5% starting in the same year. Furthermore, at the time that the government made this announcement, it also introduced two new personal income tax (PIT) measures — increasing the age credit and pension income splitting — in order to appease the public sentiment that seniors were adversely impacted by the change in the taxation treatment of income trusts. These two PIT measures are being implemented immediately.

The net effect of these changes is that, by the government's own estimates, it will lose about $3.8 billion between 2006–07 and 2009–10 in PIT revenues before it begins to recoup revenue via the taxation of income trusts on the CIT side.

PIT revenues are also being depleted by the wide range of PIT cuts introduced in Budget 2006. The Budget introduced changes to PIT rates as well as the basic personal amount, which the Finance Department stated would cost some $2.75 billion in 2006–07. In addition, the Conservatives platform promised a buffet of what we refer to as "designer" tax cuts: piece-meal tax cuts motivated more for electoral expediency than to achieve some consistent public policy purpose. One could be forgiven for assuming that the Conservative Party's polling firm crafted a hodgepodge of measures such as a children's fitness credit, a textbook tax credit, a tax credit for transit passes, a change in the capital gains tax treatment of fishers, and so on. These designer tax cuts needlessly complicate the tax system, and they introduce new sources of horizontal inequity (the different tax treatment of similar taxpayers based on arbitrary characteristics).

Although these designer tax cuts deliver only small amounts of money per qualified taxpayer, in aggregate they are a large drain on the Treasury. By the Finance Department's calculations, these tax cuts will cost more than $2 billion in 2006/07.

While the preliminary results published in the Fiscal Monitor indicate that PIT revenues have been strong early in this fiscal year, the impact of the PIT cuts together with the downward revisions in projected GDP growth, will take a toll on PIT revenues in 2005–06.

Our projected PIT revenues are $108.4 billion in 2006/07, down from the $109.3 billion projected in Budget 06. Personal income tax (PIT)/GDP ratio is 7.5% for that year, which matches the PIT/GDP ratio indicated in Budget 2006. In subsequent years, PIT/GDP remains at 7.5%.

The Finance Minister indicates that the outlook for corporate income tax (CIT) revenues is not affected by the recent income trust announcement until fiscal year 2010–2011, when a rather modest $100 million in additional CIT revenues will be generated by taxing these entities.

We regard the 2006 Budget's CIT revenues projections of the 2006 budget as rather optimistic. CIT revenues were projected at $34.5 billion by the government for 2005/06 in the 2006 Budget — a document prepared more than one month after the end of that fiscal year. Actual

TABLE 5 **AFB Projected Tax Revenues**

	ACTUAL			PROJECTED				
INCOME TAX ($BILLIONS)	**2003–04**	**2004–05**	**2005–06**	**2006–07**	**2007–08**	**2008–09**	**2009–10**	**2010–11**
Personal Income Tax	93.0	98.5	103.7	108.4	113.0	118.7	124.5	130.2
Corporate Income Tax	27.4	30.0	31.7	33.6	35.1	35.0	35.8	36.8
Goods and Services Tax	28.3	29.8	33.0	30.9	31.1	32.6	34.2	35.8
Other	32.4	36.4	37.2	38.5	39.2	40.2	41.2	42.3
Employment Insurance Revenues	17.5	17.3	16.5	15.7	16.2	17.1	17.7	18.4
Total Budgetary Revenues	**198.6**	**211.9**	**222.2**	**227.1**	**234.6**	**243.6**	**253.4**	**263.5**
PERCENT OF GDP								
Personal Income Tax	7.6	7.6	7.6	7.5	7.5	7.5	7.5	7.5
Corporate Income Tax	2.3	2.3	2.3	2.3	2.3	2.2	2.2	2.1
Goods and Services Tax	2.3	2.3	2.4	2.2	2.1	2.1	2.1	2.1
Other	2.7	2.8	2.7	2.7	2.6	2.5	2.5	2.4
Employment Insurance Revenues	1.4	1.3	1.2	1.1	1.1	1.1	1.1	1.1
Total Budgetary Revenues	**16.3**	**16.4**	**16.2**	**15.8**	**15.6**	**15.4**	**15.3**	**15.2**

NOTE Numbers may not add due to rounding

CIT revenues were $31.7 — drop of over 8.8%, despite very good pre-tax corporate profitability in that year.

The outlook for CIT revenues is being impacted by projections of declining corporate profitability. While the growth in pre-tax corporate profitability was 10.6% in 2005, the median value of forecasted pre-tax profits growth had declined to 6% in 2006 and 4% in 2007.

In future years, the reductions in the general corporate income tax rate (from 21% in 2007 to 18.5% by 2011) will squeeze the growth in CIT revenues.

In light of this profitability outlook, we project CIT revenue of $33.6 billion in 2006–07, or CIT/GDP ratio of about 2.3% of GDP. We expect the CIT/GDP ratio to diminish gradually until it reaches 2.1% of GDP by 2010–11.

In our judgement, the government's 2006 budget offered a very low estimated of GST revenue. For example, the May 2006 federal Budget estimated 2005–06 GST revenues at $31.9 billion, while the actual total for that year was $33 billion.

Our GST projections have been adjusted to reflect the one-percentage-point reduction in the GST rate introduced in July, 2006. However, our GST revenue projections are somewhat higher than those of the Finance Department in the 2006 Budget, despite the fact that forecasted nominal GDP growth rates have slowed.

In general, estimates in other revenue categories conform closely to those of Budget 2006 — although they have been adjusted downward slightly to reflect lower nominal GDP growth forecasts. The one exception to this is the non-tax "other revenue" category,[7] which has been adjusted upward owing to fact that this category exceeded Budget 2006 projections for 2005–06.[8]

On the whole, the AFB forecasts revenues that are lower than those forecast by the government in Budget 2006. To a large extent, this is the result of downward adjustments in economic growth forecasts. The AFB projects budget revenues of $227.1 billion for the fiscal year 2006–

TABLE 6 **AFB Summary Statement of Transactions**

	ACTUAL			CCPA PROJECTIONS				
LEVELS ($BILLIONS)	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11
Budgetary revenues	198.6	211.9	222.2	227.1	234.6	243.6	253.4	263.5
Program expenses	153.7	176.4	175.2	186.7	194.6	202.7	211.1	219.5
Debt Paydown (2006/07 and beyond)				3.0	3.0	3.0	3.0	3.0
Public debt charges	35.8	34.1	33.8	33.2	32.9	32.6	32.3	32.0
Budgetary surplus or deficit (-)	9.1	1.5	13.2	4.2	4.0	5.3	7.0	9.0
Accumulated deficit	**496.2**	**494.7**	**481.5**	**478.5**	**475.5**	**472.5**	**469.5**	**466.5**
PERCENT OF GDP								
Budgetary revenues	16.3	16.4	16.2	15.8	15.6	15.4	15.3	15.2
Program expenses	12.6	13.7	12.8	13.0	12.9	12.8	12.8	12.7
Debt Paydown				0.2	0.2	0.2	0.2	0.2
Public debt charges	2.9	2.6	2.5	2.3	2.2	2.1	2.0	1.8
Budgetary surplus or deficit (-)	0.8	0.1	1.0	0.3	0.3	0.3	0.4	0.5
Accumulated deficit	**40.9**	**38.3**	**35.1**	**33.3**	**31.6**	**29.9**	**28.4**	**26.9**

07 — quite close to the $227.2 billion estimated in Budget 2006.

Expenditures

On the whole, the AFB outlook for program expenditures is lower than those estimates provided in Budget 2006. The AFB projects that program spending will be $186.7 billion in 2006–07, compared to $188.8 billion indicated in Budget 2006. Similarly, in later years AFB estimates are somewhat lower than those of the Finance Department. Our lower program spending estimates reflect past experience with padding of expenditure estimates.

Our program expenditure projections assume that the government will comply with its stated intention of mandating the Treasury Board to identify "savings" of $1 billion in both 2006–07 and 2007–08, and that this exercise will continue in future years.[9] Thus the recent announcement of spending cuts does not represent the creation of newly available fiscal room; these spending cuts were merely part of the ongoing exercise that the government must perform to generate the fiscal room already portrayed in their (and our) budget projections.[10]

Debt services costs are a budget category in which padding is typically concealed. The government's estimates of public debt charges appear to be following in this tradition.

Readers should note that Budget 2006 assumed $8 billion in debt reduction (i.e., the size of the 2005–06 budget surplus as it was estimated in Budget 2006) rather than the $13.2 billion in debt reduction for 2005–06 which was disclosed in October. Thus the Budget 2006 debt service charges are somewhat overstated because they were calculated on the basis of a higher public debt. However, Canadians might be surprised to realize that paying down an additional $5.2 billion in debt actually makes only a modest difference in total debt service costs, since it produces a savings of only about $300 million. Thus the repayment of $5.2 billion creates a savings of about %1 on the roughly $33 billion cost of servicing the public debt.

Even factoring this in, however, we believe that the government has overstated the costs of servicing the public debt based on the outlook for interest rates that prevailed in May, 2006. This padding, together with some downward revision in the forecasted interest rates since May 2006, explain why the AFB debt service estimates are considerably lower than those of the 2006 federal Budget. For example, in 2006–07, the government projected its debt services charges to be $34.8 billion, while our estimate is $33.2 billion.

The Budget Balance

The AFB projects budget surpluses of $4.2 billion in 2006–07 and $4.0 billion in 2007–08. Our projections indicate that the Conservative government will have more fiscal room than was portrayed in its 2006 Budget: $3.6 billion more in fiscal room in 2006–07, and $2.6 billion more in 2007–08.

The difference in outlook between the AFB surplus forecast and that of the government can be characterized as the outcome of opposing forces. Some forces are tending to increase the projections of forthcoming budget surpluses, while some forces are tending to decrease them. At this point, the forces that enlarge future budget surplus projections are dominating.

On the one hand, padding — which we believe is still included in the Finance Department's forecast — produces AFB budget-surplus projections higher than those of the Finance Department. But, on the other hand, a worsening macroeconomic growth forecast tends to dampen AFB surplus forecasts as compared with those of the government. In addition, we believe that the slowdown in the growth of forecasted CIT revenues are also exerting downward pressure on future budget surpluses. And of course, the Conservative government's inclination to solve all manner of public policy issues with a new series of tax cuts (witness the income trust situation) is eating into budget surpluses.

While on the whole we believe that fiscal capacity is greater than was indicated in Budget 2007, we caution readers that any of the possible downside macroeconomic risks could jeopardize this fiscal room.

Moreover, since the government no longer makes provisions for "Contingency Reserves" or "Economic Prudence," any unforeseen expenses must be counted against budget surpluses. No additional allowances have been made for unanticipated events — such as expenditures required to respond to some natural disaster or other unforeseen expenses (such as the cost of evacuating Canadian citizens from Lebanon).

4 Can They Pay for What They Say?

The AFB budget surpluses forecasts are somewhat higher than those projected in Budget 2006. But does this indicate that the Conservative government has enough fiscal room to enact new measures in the next federal Budget?

Before the Conservative government can pay for new tax cuts or spending, it must first factor in the costs of meeting its promises that have not yet been enacted.

Important Conservative promises outstanding

1. Address the fiscal imbalance: One of the Conservatives' five priorities was to address the fiscal imbalance. However, debate still continues as to how the fiscal imbalance should be defined. Certainly Canadians have no idea how the federal government proposes to "fix" the fiscal imbalance.

For example, some commentators focus on fixing transfers for social programs, which has a yearly price tag of at least $4.9 billion (Council of the Federation Advisory Panel on Fiscal Imbalance[11]).

Others contend that equalization requires adjustment. According to the Expert Panel on Equalization and Territorial Formula Financing, this would cost $887 million in 2007–2008 alone, while the Council of the Federation Advisory Panel on Fiscal Imbalance estimates this would cost $4.7 billion (based on fiscal capacities of 2005–06) if 100% of resource revenues are factored in.

The Bloc Québécois' price tag for Québec alone is almost $4 billion ($2.1 billion for Equalization and $1.9 billion for transfers and child care).

While no consensus has emerged about what measures will be necessary to address the fiscal imbalance, it will clearly be costly. In addition, if the proposals mentioned above were adopted, these estimated costs would have to be paid on an annual basis.

No money was put aside in Budget 2006 to pay for the cost of this promise. Any costs incurred to address this issue must be funded out of forthcoming budget surpluses.

2. Reduce health care wait times: The Conservative government has promised to reduce health-care waiting times as one of its famous "five priorities," although it has not allocated new funds to achieve this goal.

3. Cut the GST (again): The Conservative electoral platform promised to reduce the GST rate by a further percentage point by 2010–2011. The cost of this measure is influenced by many variables including the timing of its implementation, since the cost of a cut in the GST rate grows as the economy grows. Budget 2006 indicated that the projected cost of a one-percentage-point cut in the GST in 2007 was $5.2 billion. TD Bank estimated that the cost of a further one point cut in the GST rate would cost about $6.5 billion by 2010.[12]

4. Change the taxation of capital gains: The 2006 Conservative electoral platform promised to "eliminate the capital gains tax for individuals on the sale of assets when the proceeds are re-invested within six months". This change in the treatment of capital gains is a campaign promise that faces considerable practical obstacles, as the TD Bank has confirmed.[13] As the measure is described in the Conservative platform, it is very likely that the impact of this measure will be the *de facto* elimination of taxation on capital gains. The Conservatives' requirement that capital gains be re-invested within six months to avoid taxation is so easily evaded that only the least sophisticated of taxpayers would still pay tax on capital gains. For example, anyone who realizes a capital gain could immediately buy some other investment, such as a Treasury bill. After holding the Treasury bill for a few days, it could be re-sold with no (or negligible) capital gain. This simple action would thus eliminate any tax liability.

The Conservative platform costed this capital gains tax promise at a total $900 million over 5 years — although, by neglecting to inform us when and how it would be implemented, we are not able to derive a yearly cost for this promise. The government's estimate is undoubtedly low, or, in the words of Don Drummond: "It seems to us that the costs of the proposal to defer capital gains taxation on investment rollovers has been grossly understated."[14] The Globe and Mail reports that this measure could cost as much as $2 billion per year.[15]

5. Defence: The Conservatives' electoral platform promised $5.325 billion in additional spending for National Defence between 2006–07 and 2010-11. Budget 2006 incorporated $ 1.1 billion between 2006–07 and 2007–08 in additional spending that was explicitly related to defence. ($400 million in other expenditures related to border security may also be judged by the Conservatives as counting towards the fulfillment of this $5.325 billion defence spending promise.[16]) Thus, we should expect the Conservative government to announce something in the order of at least $3.8 billion in further new defence spending in fulfillment of this promise.[17]

It is entirely possible that fulfilling these outstanding promises alone would exhaust the forthcoming budget surpluses, and might put the government into deficit (particularly if the "fiscal imbalance" proves expensive).

In judging the affordability of these measures, readers should note that the above measures have budgetary implications beyond the year in which they are implemented. For example, a GST cut does not just cut into tax revenues in the year in which it is enacted; the lower GST rate reduces government revenues for each year into the future. Because many of these promises have recurrent costs, the affordability of honouring all of these outstanding promises is doubtful.

How will the pay for what they say?

In their attempt to win a majority government, the Conservatives will be tempted to make new promises. But we believe that the government has scant fiscal room to accommodate any new tax cuts or spending increases if the government implements its outstanding promises.

TABLE 7 Hypothetical pattern of spending cuts required to achieve $22.5 billion in savings over 5 years as produced by TD Bank

	2006–07	2007–08	2008–09	2009–10	2010–11	5 year total
Spending savings	2	3	4.25	5.75	7.5	22.5

SOURCE Don Drummond, "Peering into the Conservatives Fiscal Plan: more spending restraint Required than you might think". TD Economics Special Report February 28, 2006 TD

How might the government find extra cash to deliver on its outstanding promises and still make new ones? Based on the assumption that the Conservative government will not wish to run a deficit, we present three of the most obvious options below.

1. The Conservative government can make deeper spending cuts

We see indications that the Conservatives intend to take this route, particularly if they win a majority government and can thus make spending cuts with greater political convenience. The Conservative platform indicated that they intend to save $22.5 billion between 2006–07 and 2010–11 by "moderating spending on grants and contributions and in government departments and agencies".[18] These spending cuts are over and above the "reallocation" made when the Conservatives cancelled the national child care plan and the climate change fund that the previous Liberal government had incorporated into previous spending estimates.

How significant are budget cuts of this size? Just for illustrative purposes, consider this: the Liberal government's national child care program was budgeted to cost $5.5 billion between 2006–07 and 2010–11. Thus, the Conservative cuts amount to cutting more than four national child care programs.

How might the Conservatives cut spending to achieve these targets? Don Drummond of the TD Bank performed the useful exercise of providing a "guesstimate" of the annual totals required to meet this goal (see Table 7). As Table 7 indicates, the cost-cutting required in the later years of the budget could be quite dramatic.

2. The Conservative government can renege on its public debt pay-down promise

The $3 billion annually that the Conservative platform promised to allocate to debt repayment could be redeployed to pay for new tax or spending promises.

Perhaps the government will claim that the $13.2 budget surplus in 2005–06 provided such an unexpectedly big debt repayment that it feels it can refrain from fulfilling its debt repayment promise.

If the government makes declarations that it is unexpectedly ahead of its debt repayment hopes because it was surprised by the extent of the 2005–06 surplus, we would find such a claim disingenuous. The CCPA provided a forecast to the House of Commons Finance Committee in October of 2005, and at that time we foresaw a budget surplus of $11.4 billion, a far cry from the $8 billion portrayed in Budget 2006.

In our opinion, when the $3 billion in annual debt reduction promised in the Conservative electoral platform was made, the Conservatives should have realized that the 2005–06 budget surplus would be quite large.

3. The Conservative government can privatize assets

Governments that wish to generate windfall cash inflow can sell assets. For example, discussions about the sale of Atomic Energy of Canada and Canadian Mortgage and Housing Corporation's

(CMHC) lucrative mortgage insurance activities have been reported in the press.

Privatizing assets, however, is a short-term solution to the problem of fiscal capacity. Privatizing assets often leads to fiscal squeezes in the future, as the government must forgo the ongoing revenue produced by the asset (for example, CMHC's mortgage insurance activities generate roughly $1 billion per year for the government) or must incur costs in the future to purchase the services provided by the asset (this happens when buildings owned by the government are sold and rented back for the government's use).

Conclusion
Can They Pay for a New Tax Cut Agenda?

According to our forecast, the Conservative government finds itself with somewhat higher budget surpluses than were expected in the May 2006 Federal Budget. Whether or not this fiscal room is enough to pay for outstanding Conservative promises (the further GST cut, reduction in health care waiting times, the fiscal imbalance, further defence spending and changing capital gains taxation) is a very debatable point. The total price tag on these existing promises is not clear, and significant downside risks to our budget forecast indicate that the fiscal capacity portrayed in our forecasts may be jeopardized.

What is clear is that there is not sufficient fiscal room to fund new tax or spending promises on top of the promises that the Conservatives have already made. Further Conservative promises will have to be financed via spending cuts or other means (such as the sale of assets or the reduction in debt repayment).

In light of the AFB fiscal forecast, we feel it would be a grave mistake to embark on a program of new tax cuts, as the Finance Minster has suggested that the Conservative government intends to do. Ironically, the government may well cite "bad" economic news as justification for a new round of tax cuts. The government may well proclaim that declining growth forecasts justify tax cuts as the centerpiece of a new productivity and competitiveness agenda.

If the Conservatives argue that tax cuts will cure what ails us, the burden of proof is on them to explain why. Given that the Bank of Canada argues that the Canadian economy is operating above its productive capacity level, and that no further domestic demand stimulus is required, there is no justification for cutting personal income taxes or sales taxes.

Nor are corporate tax cuts the panacea to productivity woes the government may claim. Jim Stanford's analysis of corporate tax cuts indicates that they have not given rise to increased investment in recent years. Quite the contrary: the effective tax rate paid by corporations fell by almost 5 percentage points between 2000 and 2004, and business investment has weakened significantly in Canada, not improved, since the federal corporate tax reductions came into effect.[19]

We strongly suspect that further tax cuts have little to do with economic rationale and more to do with the Conservative government's electoral situation. But a new round of substantial tax cuts will deplete the federal Treasury, thus rendering large spending cuts inescapable. Unfortunately, the repercussions of spending cuts of a magnitude comparable to the $22.5 billion envisioned in the Conservative electoral platform will have widespread consequences, most of which will not likely be evident until after the next election.

Notes

1 "Tories Plan More Tax Cuts" by Paul Viera. National Post, A1 October 17 2006.

2 As Budget 2006 indicates, totals sometimes do not add due to rounding.

3 Drummond, Don. "The Status Quo Federal Fiscal Outlook: Not Much Room Here" TD Economic Special Report, www.td.com/economics.

4 We consulted the following forecasts:

1. Bank of Canada. "Monetary Policy Report", October 19th, 2006.
2. BMO Financial Group. "North America Outlook: forecast Tables", November 14th, 2006.
3. BMO — Nesbitt Burns. "Canadian Economic Outlook", November 3rd, 2006.
4. Canadian Imperial Bank of Commerce. "World Market Forecast", September 27th, 2006.
5. Canadian Imperial Bank of Commerce. "Monthly Indicators", November 7th, 2006.
6. Desjardins. "Scénario Financier Mensuel", November 6th, 2006.
7. Donner, Arthur. "November 2006 Market Comment", November 13th, 2006.
8. Export Development Canada. "Global Export Forecast Update", July 2006.
9. National Bank of Canada. "Monthly Economic Monitor — October 2006", September 22nd, 2006.
10. Royal Bank of Canada. "Canadian Economic Forecast", October 2006.
11. Scotiabank. "Scotiabank Forecast Update", November 3rd, 2006.
12. TD Economics. "TD Quarterly Economic Forecast", September 18th, 2006.

5 October 2006 Monetary Policy Report.

6 "U.S. Slowdown Underway, Canada in for a Bumpy Ride", TD Quarterly Economic Forecast, September 18, 2006. www.td.com/economics.

7 "Other revenues" includes revenues from Crown Corporations, foreign exchange revenues, and revenues from the sale of goods and services.

8 Some of the extra revenues in this category were one time only increases (such as a $1 billion adjustment resulting from a change in the accounting treatment of Canada's subscriptions in the IMF), and were discounted when we made our own forecast.

9 See Budget 2006, page 171.

10 www.tbs-sct.gc.ca/media/nr-cp/2006/0925_e.asp.

11 "Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance" 2006.

12 Drummond, Don. "The Status Quo Federal Fiscal Outlook: Not Much Room Here", TD Economic Special Report, www.td.com/economics.

13 "First, the proposal to allow the deferral of capital gains taxes if the proceeds are reinvested within six months time is more complicated than it looks on the surface. The policy will take considerable time to design and the costs would likely far exceed the estimate in the Conservative fiscal plan. It will also be difficult to administer." (Craig Alexander, Outlook for Federal Fiscal Policy TD Economics Special Report. February 15, 2006. www.td.com/economics.)

14 Don Drummond. "Peering into the Conservatives Fiscal Plan: more spending restraint Required than you might think", TD Economics Special Report February 28, 2006.

15 "Flaherty revives Tory Pledge to slash Capital Gains Tax". Report on Business, B1 Globe and Mail, October 31, 2006.

16 Budget 2006, page 139.

17 However, this approximation would have to be altered to the extent that spending is on capital assets that can be amortized over their lifetime; it may also be true that costs of achieving their Defence objectives have escalated beyond that which was envisioned when the Conservatives costed this election promise.

18 "Table 3, The Conservative Fiscal Plan."

19 Jim Stanford. "Protesting Too Much; The Rhetoric and Reality of Corporate Tax Cuts" www.caw.ca/visual&printlibrary/speeches&briefs/briefs/protestingtoomuch.pdf.

APPENDIX TABLE **Comparison of Net and Gross Measures of Fiscal Transactions** (Percent of GDP)

	BUDGETARY REVENUES		PROGRAM EXPENSES	
YEAR	NET (PREVIOUS METHOD)	GROSS (CURRENT METHOD)	NET (PREVIOUS METHOD)	GROSS (CURRENT METHOD)
1983–84	15.5	15.9	18.4	18.8
1984–85	15.7	16.0	18.5	18.7
1985–86	15.7	16.0	16.9	17.2
1986–87	16.6	16.9	16.9	17.1
1987–88	17.1	17.4	16.7	17.0
1988–89	16.9	17.3	15.7	16.1
1989–90	17.2	17.6	15.3	15.8
1990–91	17.1	17.6	15.5	16.0
1991–92	17.9	18.4	16.2	16.7
1992–93	17.2	17.8	16.8	17.4
1993–94	16.0	17.0	15.7	16.8
1994–95	15.9	17.0	14.9	16.0
1995–96	16.2	17.3	13.8	14.9
1996–97	16.8	17.9	12.2	13.3
1997–98	17.2	18.2	12.1	13.0
1998–99	17.1	18.1	12.0	12.7
1999–00	16.9	18.0	11.2	12.1
2000–01	17.0	18.1	11.0	12.1
2001–02	15.5	16.6	11.3	12.3
2002–03	15.4	16.5	11.6	12.7
2003–04	15.3	16.4	11.6	12.7
2004–05	15.4	16.4	12.6	13.7

SOURCE Fiscal Reference Tables, Department of Finance, 2005 and 2006.

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