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Debunking the U-shaped Budget Surplus

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The Old Federal Budget Surplus Game

Just when Canadians had caught on to the old budget surplus game, it appears that the Liberal government has moved the goal posts.

For years now, the Liberals have low-balled their budget surplus projections. Why? By refusing to acknowledge the funds at their disposal, they have shielded themselves from public pressure to use these surpluses. Since budget surpluses are automatically used to pay down debt after fiscal year-end, public debate about what to do with these funds was pre-empted until it was too late to use them for other purposes.

While downplaying surpluses did insulate the Liberal government from pressures to rebuild the social programs cut during the deficit-fighting years, it created another problem. The blatant and repeated inaccuracy of federal government surplus forecasts began to take its toll on public confidence in the government's projections. With the CCPA's Alternative Federal Budget estimating the surplus much more accurately than the government year after year, the government's reputation for fiscal candor was being undermined.

The Liberal government needed a new tactic to repair its tattered forecasting reputation, yet still protect it from the pressures of full public debate over what to do with its surplus.

The political advantages of the new U-shaped budget surplus

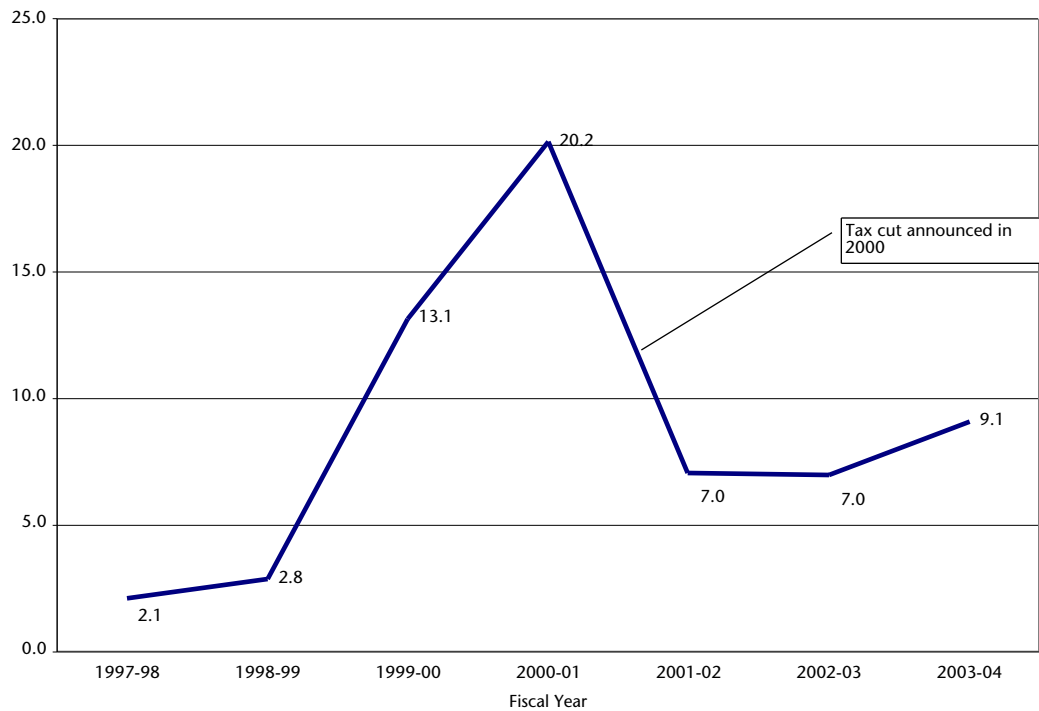
The government now presents a U-shaped budget surplus projection. It provides a plausible surplus projection for the current year, low-balls budget surpluses in upcoming years, and argues that these surpluses will grow again in the more distant future.

The new budget surplus projections respond to many of the difficulties encountered by the old game of budget surplus low-balling. These U-shape projections also set the stage for some other actions that the government may find politically expedient.

This U-shaped budget surplus allows the Finance Minister to claim that he is fixing the government's forecasting problem. Discrepancies between the government's current-year projections and reality are relatively quickly apparent: we need only wait until the year-end financial report to discover this lowballing. It is more difficult, however, to hold the government to account for low-balling future years' surplus projections, since the evidence won't be available for several years.

Because the surplus nosedives after this year, the government can continue to claim that it is too strapped for cash to entertain expensive new initiatives. Since any serious attempt to rebuild social programs will require an ongoing spending commitment, these options are off the table. The debate on how to spend the surplus becomes confined to proposals requir-

Figure 1: Federal budget surplus 1997/98 to 2003-04



ing only immediate bursts of money from the current surplus.

The U-shaped budget surplus projections also enhance the case for setting aside some of the current surpluses into “trust” funds. Trust funds enable the government to take credit for acting on its promises, without incurring the ongoing commitment implied by funding an initiative within its upcoming budgets. As they are now constituted, however, these trust funds are not an ideal way to accomplish public policy objectives. The Auditor-General has recently pointed out that these trust funds are rife with problems of accountability and transparency.

Finally, the U-shaped budget surplus projections help to persuade Canadians of the validity of cutting existing government spending. The Expenditure Review Committee is charged with cutting \$12 billion from forthcoming spending to fund new priorities over the coming years. It would not be necessary to make such substantial cuts to existing programs if the government acknowledged that there were sizeable budget surpluses foreseeable in upcoming years.

Is there really a U-shaped surplus?

It is odd indeed to have a federal budget surplus forecast that makes a U-turn. Unless some dramatic event happens (such as a recession or a big change in government taxation or spending), budget balances have tended to continue on their present course.

Consider the recent evidence. The federal budget surplus has tended to be on an upward trajectory (see *Figure 1*). The major exception to this happened when the \$100 billion tax-cut package was announced in 2000, in combination with weakened economic activity, produced a steep drop in budget surpluses (from about \$20 billion to \$7 billion). Thereafter, budget surpluses resumed their upward trend.

To examine the plausibility of the federal government’s “U-shaped” budget forecast, the AFB performed its own “status quo” projections. Leaving aside any possible new announcements about spending or taxation in the forthcoming federal budget, we wanted to see just how big a surplus the government is likely to be working with in future years.

Our assumptions are as follows:

1. For our macroeconomic variables, we adopt the recent estimates set out by the Bank of Canada and by CIBC World Markets. Economic growth forecasts have been revised downwards since the publication of the government's Economic And Fiscal Update, and our analysis has taken this into account.
2. We adopt the government's own spending estimates. It must be emphasized that the AFB believes this to be generous estimate of government spending, in part because savings expected to be generated by the Expenditure Review Committee are not reflected in the estimates provided in the November 2004 *Economic and Fiscal Update*.
3. Because these spending estimates include the impact of the health care and equalization announcements in the fall, **it is not legitimate to say that the U-shape is caused by new health care or equalization expenses: these have already been factored in.** We also have adjusted these spending estimates upward to reflect recent announcements, such as tsunami relief and off-

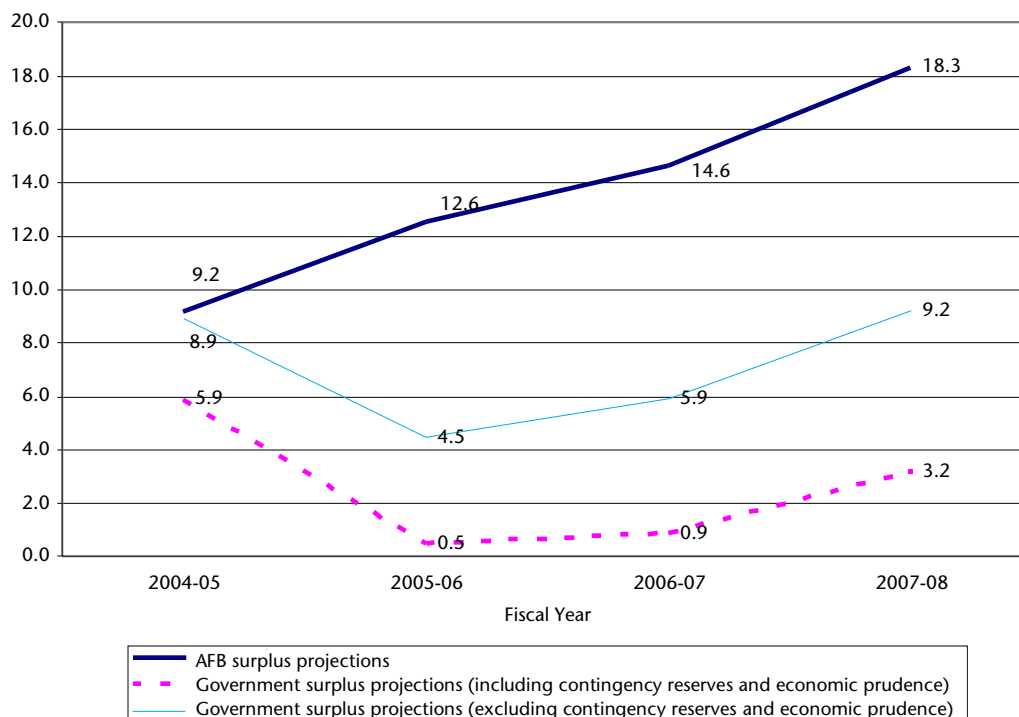
shore agreements with Newfoundland and Labrador and Nova Scotia.

4. We believe the government has overestimated its future debt-servicing costs in the November 2004 *Economic And Fiscal Update*. We accept its debt-servicing cost estimates for the current year, and freeze them at that level in upcoming years¹. However, as the AFB explains, this is a highly cautious estimate of public debt charges.

The U-shape characteristics of the government's surplus projections is generated on the revenue side of its budget. The government states that its revenues, expressed as a proportion of GDP, will plummet from 15.3% in the last fiscal year to 14.6% in the coming fiscal year.

The AFB sees no justification for such low government revenues. Government revenues dropped precipitously in 2001, but that was a result of the \$100 billion tax-cut package in the context of weak economic conditions. We can see nothing in the government's rationale that would plausibly cause revenues to plummet again. To be cautious, the AFB adjusts revenue/GDP down gradually. (It must be emphasized that a strong case can be made that revenue/GDP will not even fall

Figure 2: Federal budget surplus projections : AFB vs. federal government



by as much as the AFB has assumed. However, we have elected to err on the side of caution).

A comparison of the federal government's and AFB's surplus projections

Based on the assumptions employed by the AFB, there is no U-shaped budget surplus. In fact, the AFB projections depict a budget surplus that continues to climb: \$9.2 billion for the current fiscal year, and \$12.6, \$14.6 and \$18.3 billion for the upcoming three fiscal years. *This means that the government has over \$45 billion in forthcoming budget surpluses.*

This is in strong contrast to government projections, which depict significantly less spending room. Once contingency reserve and economic prudence is subtracted, the government has less than \$5 billion of available spending room in the upcoming three fiscal years. Figure 2 shows the difference between the

government's surplus projections and the AFB's surplus projections (under status quo assumptions).

Just as Canadians are beginning to generate public debate on how to spend budget surpluses, we should not allow the debates to be foreclosed by these dubious U-shaped budget surplus projections. More urgent still, we should not let these questionable projections convert the debate about new spending priorities into a rationalization for further spending cuts.

Endnotes

- ¹ The AFB believes that freezing debt service charges to be a more realistic assumption than the rising debt service charges depicted by the government's 2004 Economic and Fiscal Update. However, even if the government's estimates of this public debt charges were incorporated into the remainder of our analysis, it would not generate a U-shaped budget surplus.