Canada's Fiscal Imbalances

History and Options for the Future

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The rational discussion of the fiscal options available to Canada in the upcoming years should be based on shared knowledge about current conditions, historic developments, and the likely effects of adopting alternative policies. This chapter presents, first, a series of graphs (figures 1–9) that summarize some facts about Canada's recent fiscal history and how the deficit was eliminated. A second series of graphs (figures 10–13) shows projections of future revenues, spending levels, and surpluses. Finally, a third series of graphs (figures 14–18) shows debt and spending programs in relation to national income in an historic context. Simulations of the use of the future surpluses put the resultant future ratios into an historic perspective.

Series 1: How the deficit was eliminated

The graphs in this section show first the most highly aggregate data on spending and revenues. These data are then broken down into main components and these, in turn, are broken down to reveal increasing details. All spending and revenue estimates for the period 1993/94 through 1998/99 are from successive issues of the *Budget Plan* released annually by the Government when each year's budget is presented to parliament. The figures for 1996/97 given in the *1997 Budget Plan* were corrected according to *The Economic and Fiscal Update* published in October 1997. The years 1997/98 and 1998/99 equal these updated figures plus the changes indicated in the *1997 Budget Plan*.

Comment on figure 1: The trend in imbalances between 1993/94 and 1998/99 is impressive by historic and international standards. The deficit of $40 billion in 1993/94 turned into a surplus of $4.1 billion in 1998/99.

Comment on figure 2: The deficit was eliminated predominantly through revenue increases of $33.4 billion (equal to 72.5 percent) while the net decrease in spending was only $12.7 billion (equal to 27.5 percent of the original deficit).

Comment on figure 3: The increased revenues were obtained mainly through increased collection of personal income tax (56.9 percent), corporate income tax (26.7 percent) and excise taxes (GST) and duties (12.2 percent).

Comment on figure 4: The net decrease in spending is composed of reduced program spending of $20.7 billion and an increase of $8 billion for servicing the debt created by the deficits in the early years.

Comment on figure 5: Note that the increase in the size of the debt = $111.1 billion; increase in interest paid = $8.0 billion; interest rate on increased debt = 7.2%.

Comment on figure 6: Transfers to persons dropped only $1.2 billion (5.7 percent of the total). The reduction of $20.7 billion in program spending was achieved mainly through cuts in direct program spending of $11.2 billion and cuts in transfers to other levels of government of $8.3 billion. The latter cut, "downloading" the deficit on provincial governments, represents 40.1 percent of all reductions in program spending.

Comment on figure 7: The reduction in net transfers to persons of $1.2 billion was the result of a reduction in payments of unemployment insurance benefits of $4.2 billion and an *increase* in transfers to the elderly of $3 billion.

Comment on figure 8: The reductions in transfers to other levels of government were accomplished primarily through cuts in Canadian health and social transfers of $6.9 billion (83.1 percent of total) and cuts of only $1.4 billion (16.9 percent) in other transfers.

Comment on figure 9: Subsidies and transfers to Indians and Inuit *increased* by $1.1 billion, spending on defence was cut by $1.4 billion, and all the other program spending absorbed the bulk of the cuts of $11 billion.

Figure 1: Federal Spending Imbalances

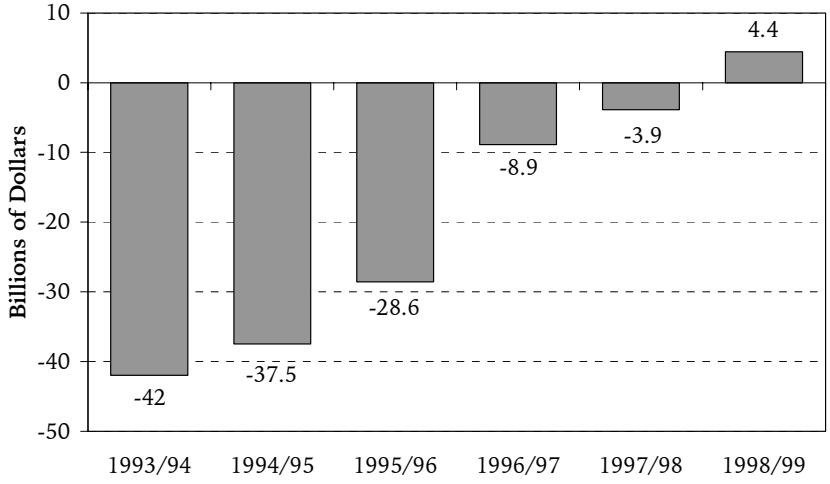


Figure 2: Sources of Deficit Elimination

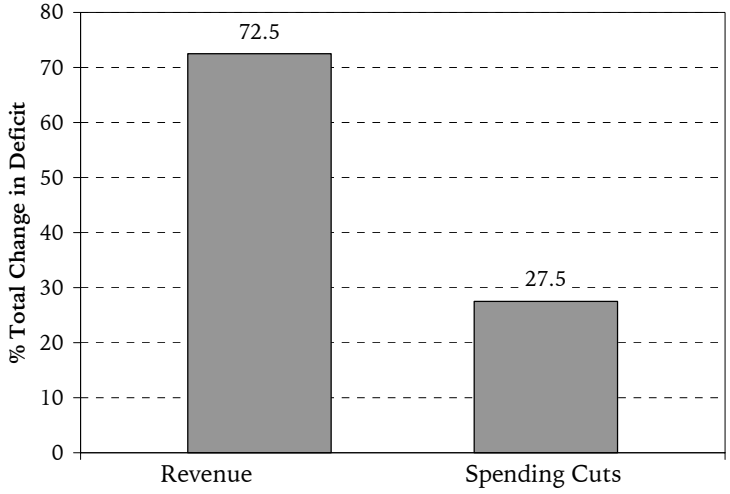


Figure 3: Sources of Increased Revenue (% of $33.4 billion)

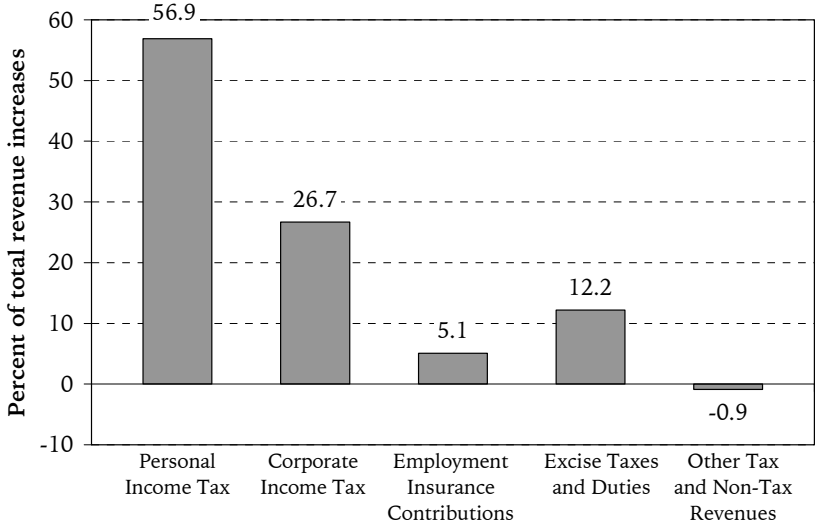


Figure 4: Sources of Changed Spending

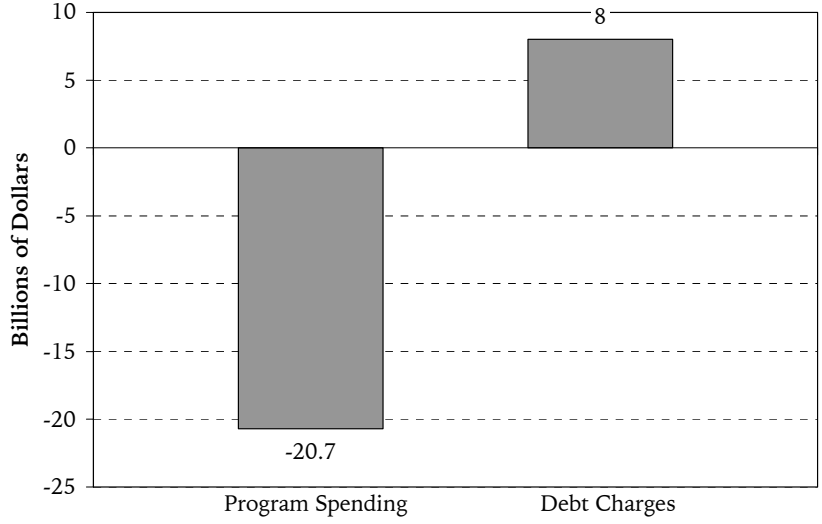


Figure 5: Some Facts about Interest on Debt

Fiscal Years	1993/ 1994	1994/ 1995	1995/ 1996	1996/ 1997	1997/ 1998	1998/ 1999
Interest paid ($billion)	38.0	42.0	46.9	45.5	46.0	46.5
Size of debt ($billion)	508.2	545.7	574.3	593.3	610.3	619.3
Interest rate on debt (interest paid/size of debt)	7.5	7.7	8.2	7.7	7.5	7.4

Figure 6: Sources of Change in Program Spending

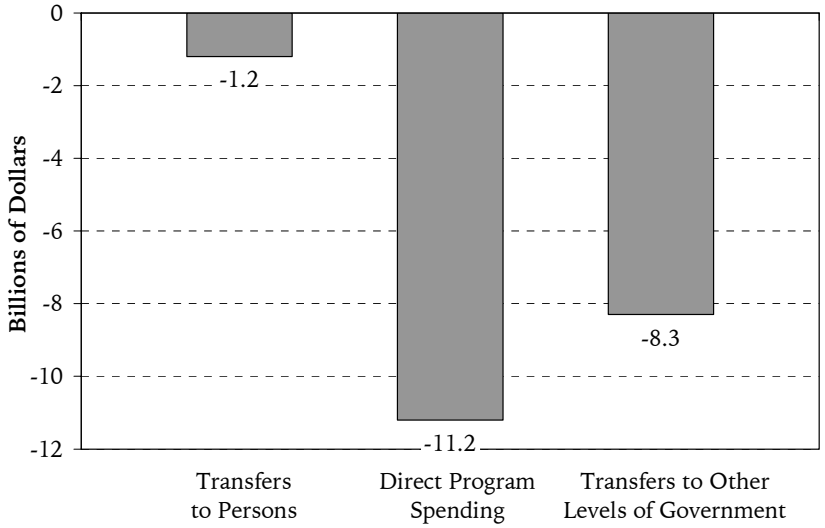


Figure 7: Changes in Transfers to Persons

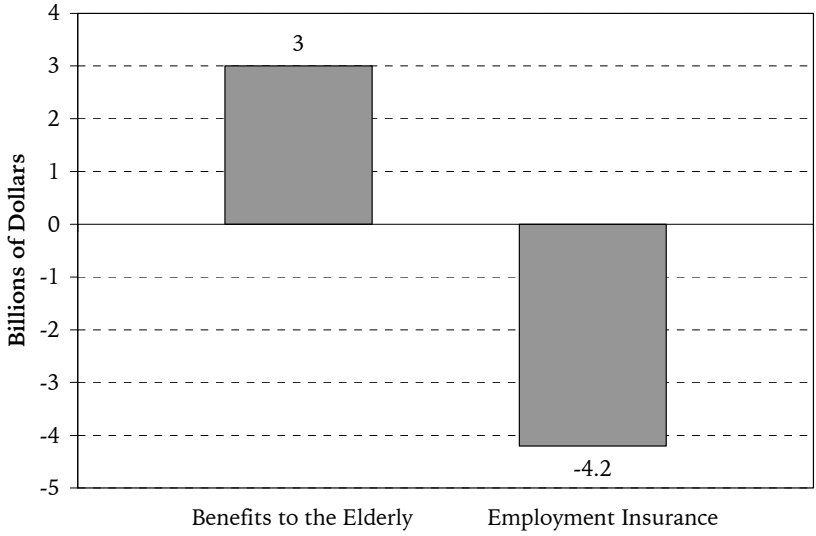


Figure 8: Transfers to Other Levels of Government

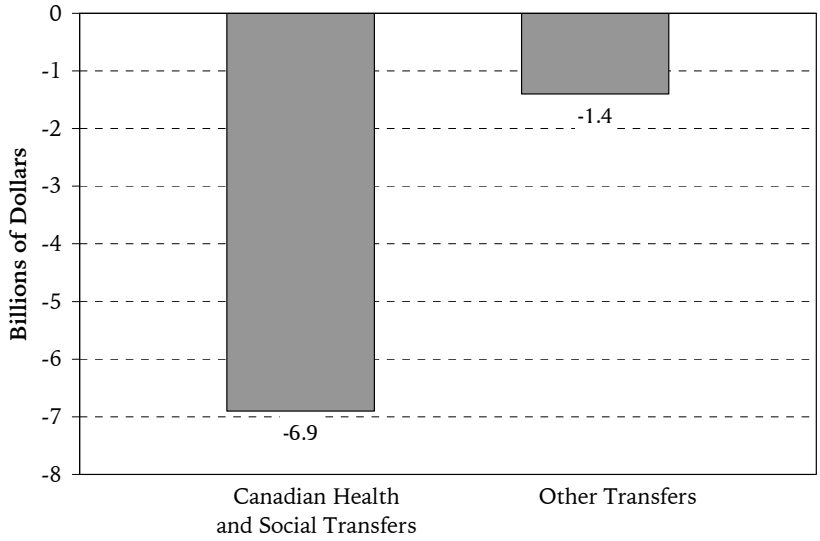
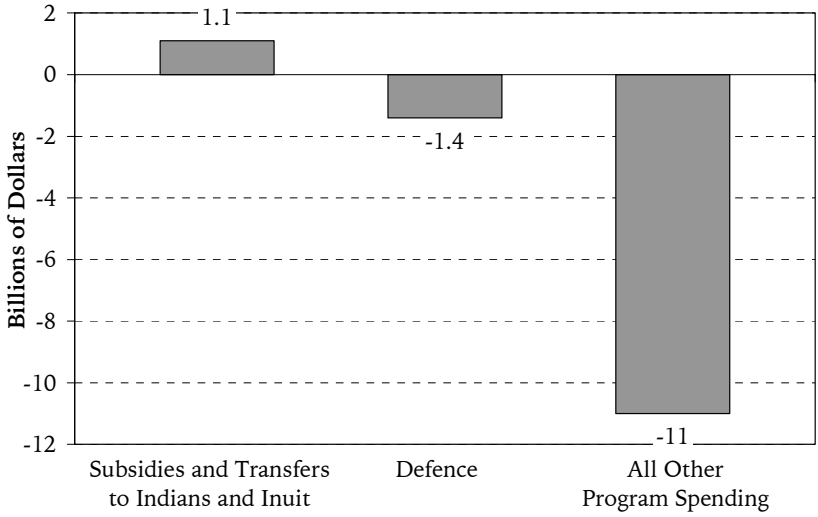


Figure 9: Changes in Direct Program Spending



Series 2: Projections of revenue and spending

My projections for the five years following 1998/99 are based on the simple assumption that the next five years will bring more or less the same revenue growth as did the preceding five years; *i.e.*, that there will be some years with good economic conditions and some that are marred by slower growth because of a cyclical downturn or a shock like that coming from the Mexican crisis in 1994. It seems reasonable to expect, therefore, that revenues from personal income tax will continue to grow at an annual average rate of 6.5 percent.

The annual rate of increase in revenue from corporate income tax was even higher than that from the personal income tax, given the low levels in 1992/93 after the recession. I assumed, therefore, that the growth rate of income from corporate income tax over the next five years will only be 4.6 percent annually, the rate for the years 1995 through 1998. Revenue from employment insurance premiums grew at 1.75 percent and that from excise taxes and duties at 2.9 percent annually during the base period. I assumed that these rates will be repeated for the following five years.

I assumed that discretionary spending will remain fixed at its 1998/99 levels for all categories except the cost of servicing the debt

and providing benefits to the elderly. The cost of servicing the debt is reduced every year by the interest saved through the use of annual surpluses to lower the debt; I assumed an interest rate of 8 percent. Benefits to the elderly are assumed to rise at an annual rate of 3.3 percent; during the base period, they rose 2.8 percent per year between 1993/94 and 1998/99. I added one-half of a percentage point to this rate to reflect the increasing number of retirees in Canada.

Comment on figure 10: Assuming broadly that revenue growth during the five years after 1998/99 will be the same as it was during the preceding five years, total revenues will be $187 billion in 2003/04.

Comment on figure 11: Assuming broadly that all spending programs remain unchanged at their 1998/99 level and that interest payments are reduced through debt retirement, total spending in 2003/04 will be $140 billion.

Comment on figure 12: The projected revenue and spending developments result in a $46.7 billion surplus in 2003/04.

Comment on figure 13: The graph shows the annual spending imbalances, actual and projected. They are equal to the difference between revenues and spending shown in figure 12.

Figure 10: Actual and Projected Revenue

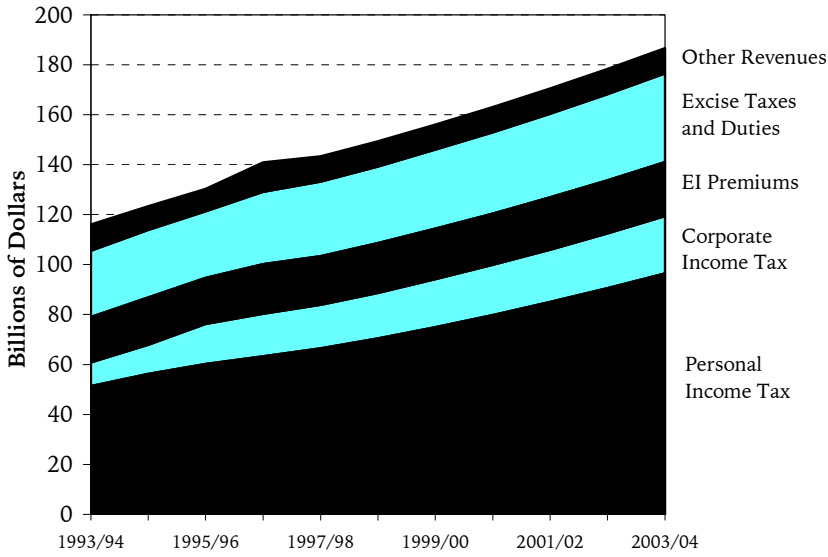


Figure 11: Actual (1993 –1998) and Projected Spending

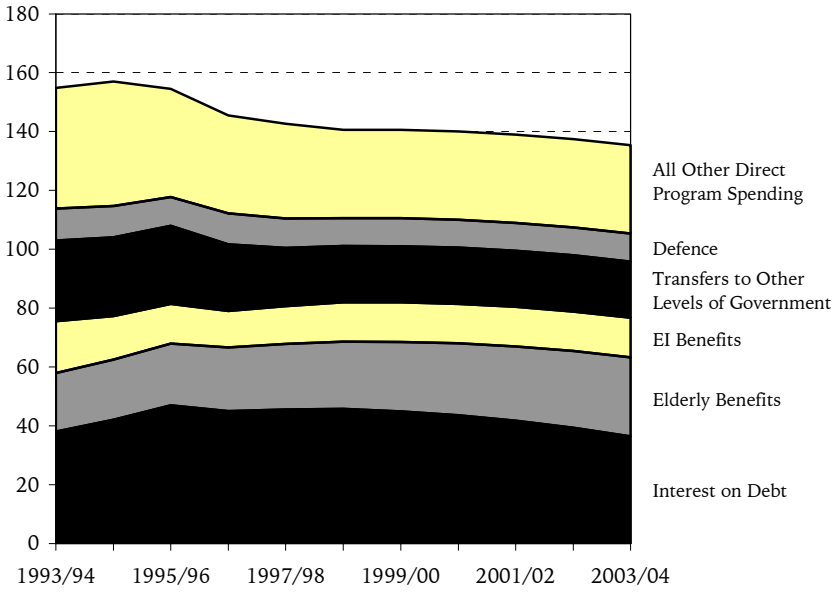


Figure 12: Total Revenues and Spending

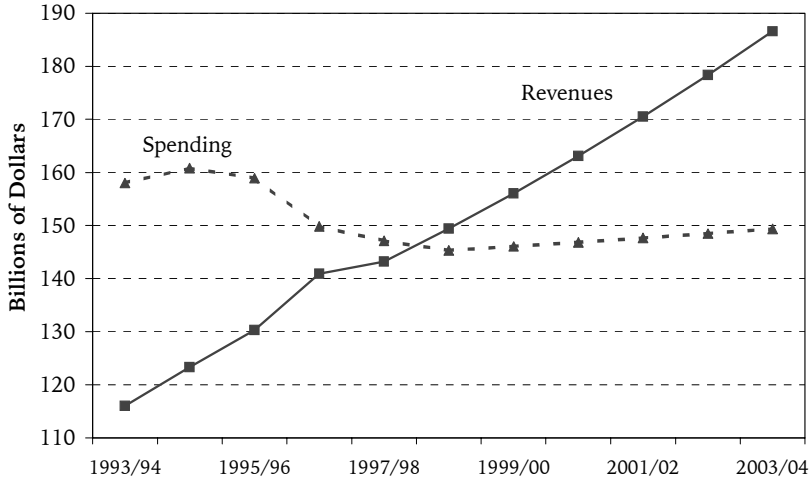
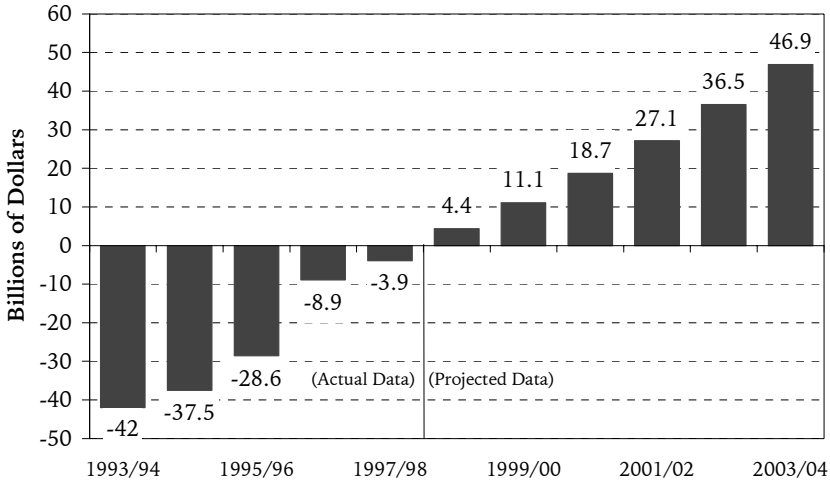


Figure 13: Federal Spending Imbalances



Series 3: Simulated effects of policy measures

The final section of this paper presents the ratio of the federal gross debt to GDP in historic perspective from 1970 to 1997. For the following years to 2003/04, the ratio is simulated assuming that GDP will grow at 2.5 percent per year and that none, all, or one-half of the projected surpluses are used to reduce the existing debt.

A second simulation is designed to provide insights into the size of some major categories of government spending relative to the size of the economy. For this purpose, I would have liked to use the spending categories found in recent Budgets. Unfortunately, Statistics Canada has readily available only spending in categories that seem to have their origin in Musgrave's well-known taxonomy: Federal Expenditures on Goods and Services (including investment), Transfers to Persons, and Transfers to Other Levels of Government. I plotted the ratios of spending in these three categories relative to GDP for the years 1970 to 1996. For the following years to 2003/04, I assumed that spending was frozen at the 1996 levels and that GDP was growing at an 2.5 percent annually.

The final simulation involves the ratio of revenue from personal income tax to GDP since 1970 and projected into the future on the assumption that none, all, or one-half of all surpluses are applied to the reduction of tax rates.

Comment on figure 14: The debt to GDP ratio has risen steadily and steeply after 1981. This trend has peaked in 1996. Declines in the ratio have taken place since then and will continue at rates dependent upon the government's use of the fiscal surplus.

Comment on figure 15: If the total amounts of the budget surpluses are applied to debt reduction and the economy grows at 2.5 percent annually, the ratio of debt to GDP will fall quickly. In 2003/04, it will be 51 percent, equal to that of the mid-1980s.

Comment on figure 16: If expenditures on goods and services are kept at the 1996 levels and the economy grows at 2.5 percent annually, in 2003/04 they will be 3.2 percent of GDP, roughly half of their level in 1970.

Comment on figure 17: If transfers to persons are kept at their 1996 levels and the economy grows at 2.5 percent annually, in 2003/04 they will reach 1989 levels and transfers to other levels of government in 2003/04 will be 25 percent below their peak in 1970.

Comment on figure 18: If all fiscal surpluses were applied to reductions in the income tax, income tax receipts as a percent of GDP would drop quickly and substantially to 1.5 percent of GDP.

Figure 14: Ratio of Debt to GDP from 1970 to 2003

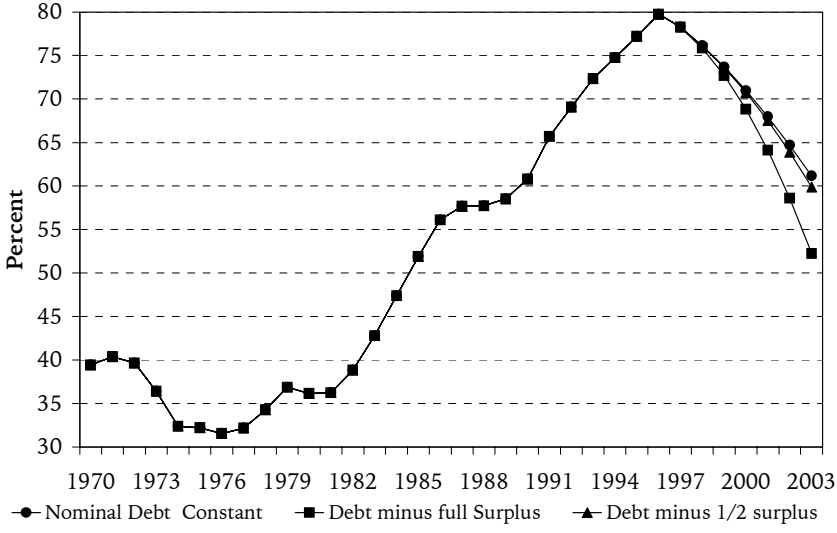


Figure 15: Ratio of Debt to GDP, details

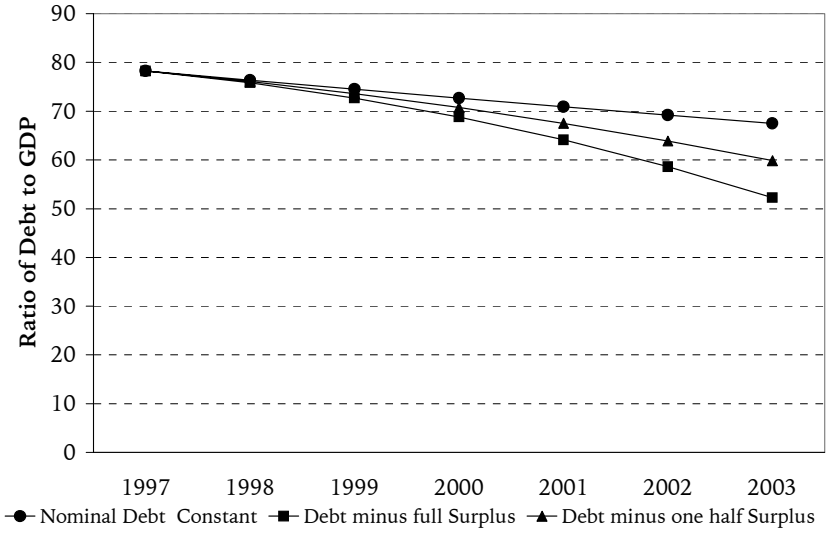


Figure 16: Ratio of Government Expenditure on Goods and Services to GDP

Figure 17: Ratios of Transfers to GDP

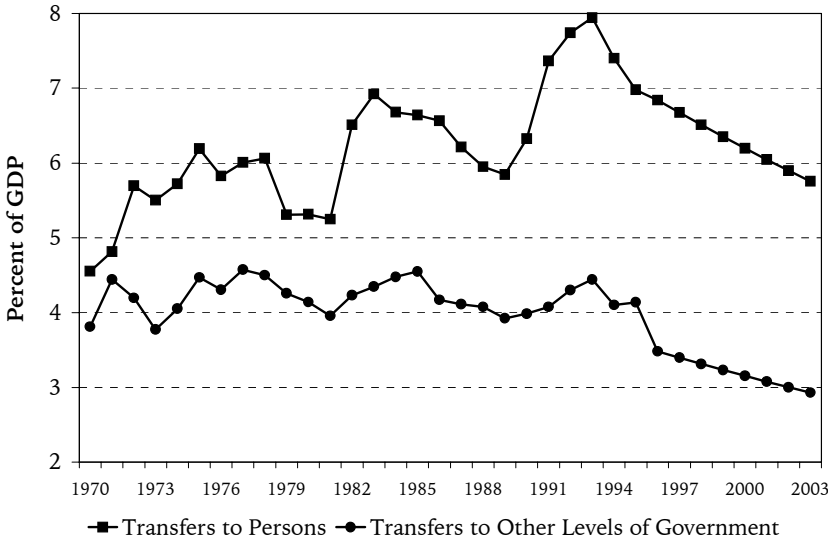


Figure 18: Ratio of Revenue from Personal Income Tax to GDP