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Back on Track

How the Federal Liberals Can Deliver Their Promised Balanced Budget by 2019/20

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MAIN CONCLUSIONS

- During the 2015 federal election, Justin Trudeau's Liberals presented a fiscal plan to Canadians that proposed three years of deficit spending of no more than $10 billion annually with a return to a balanced budget by 2019/20. After forming government, they abandoned this fiscal plan—breaking a pledge to Canadians.

- Despite a growing economy, the Trudeau government has recorded annual budget deficits nearly double the promised amount. There is no plan to balance the federal budget and projections by the Department of Finance point to budget deficits well past 2040.

- A key driver of the larger and persistent federal deficits over the course of the government's current fiscal plan is rapid growth in program spending. Since coming into office, the Trudeau government increased program spending from $253.9 billion (2014/15) to $304.9 billion (projected for 2017/18). This $51-billion increase in spending equals growth of 20.1% in just three years.

- On an annual basis, program spending has increased by 6.3% each year over the same period—much faster than federal revenue (3.3%), inflation plus population growth (2.7%), and nominal GDP (2.6%). In fact, the recent increase in spending is greater than the 2.2% average growth over the previous decade from 2005/06 to 2014/15 (excluding the 17.1% growth in 2009/10 during the recession).

- Still, the Trudeau government could make good on its pledge of a balanced budget by the end of its first mandate in 2019/20 through relatively modest spending adjustments: reducing program spending from its 2017/18 level of $304.9 billion to $301.7 billion in 2019/20—a reduction of $3.2 billion or 1.0% over two years.

- This is a modest spending adjustment compared to the 9.7% reduction over two years that was delivered by Jean Chretien's Liberals in the 1990s.

Introduction

During the 2015 federal election, Justin Trudeau's Liberals presented a fiscal plan to Canadians that proposed three years of deficit spending of no more than $10 billion annually with a return to a balanced budget by the end of their first mandate in 2019/20. After they formed the government, this fiscal plan was abandoned—breaking a pledge to Canadians. Despite a growing economy, the Trudeau government has, each year since 2016/17, actually recorded budget deficits nearly double the $10 billion proposed and expects to continue to operate in deficit for at least the entirety of its current fiscal plan, up to 2022/23. There is currently no plan to balance the federal budget. According to the Department of Finance, Ottawa will run budget deficits well past 2040, which would produce a generation of consecutive federal deficits.

The Liberal's election commitment to a balanced budget in 2019/20 is still within reach for the Trudeau government. In the upcoming 2018 federal budget, the government can take steps to return to balance in 2019/20 by adjusting its spending, which has been a key driver of the larger-than-promised budget deficits. Doing so would entail mild spending restraint compared to that of the federal Liberals in the 1990s (under then Prime Minister Jean Chretien). In other words, it is well within reach for the Trudeau government to keep its end-of-mandate pledge to Canadians. The purpose of this publication is to measure how much spending restraint would be required for the government to live up to its promise of a balanced budget within the next two years.

The publication is organized as follows. The first section reviews the current state of the federal government's fiscal position and its fiscal plan for the next two years compared to the plan proposed during the campaign. The second discusses the marked growth in spending that has occurred since the Trudeau government took office. The final section examines what it would take for the government to adjust spending to achieve a balanced budget in 2019/20.

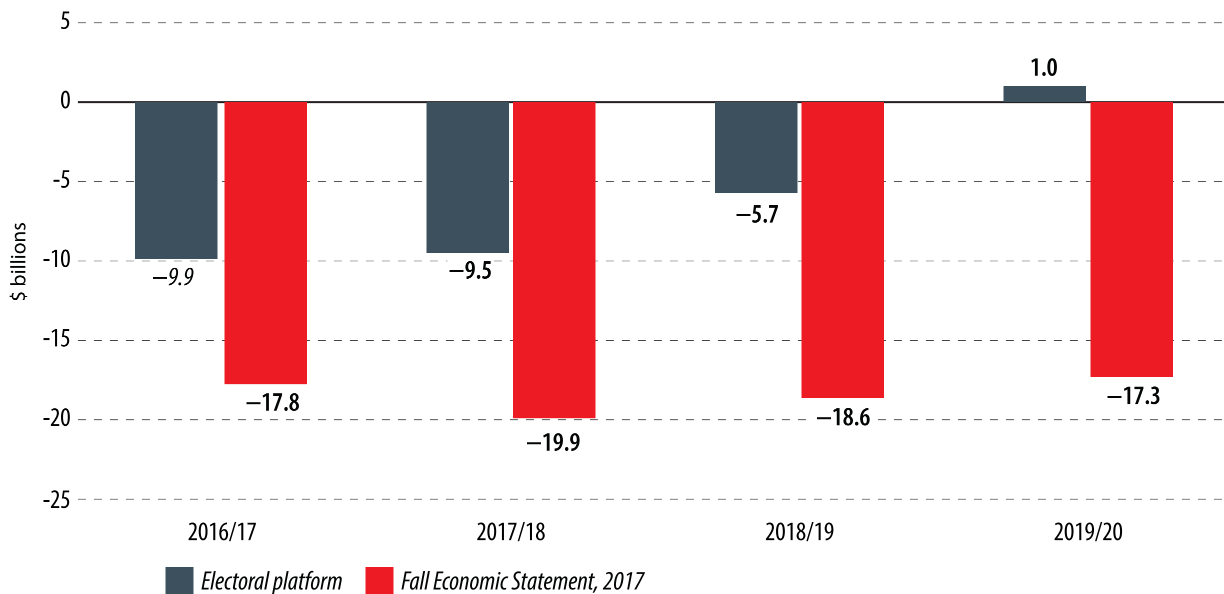
1. Federal fiscal plan—Liberal platform compared to governance

Figure 1 displays the federal budget balance as outlined in the Liberals' election platform (which included fiscal years 2016/17 to 2019/20) and as delivered by the government in its first few years in office as well as the current fiscal plan for the last two years of its mandate. The Liberal election platform called for budget deficits of just under $10 billion in 2016/17 and 2017/18 and then projected the deficit would fall by almost half to $5.7 billion in 2018/19 with a small surplus of $1.0 billion in 2019/20. In other words, the Liberals proposed a return to balance by the end of their first mandate in 2019/20. Even after assuming office, the Trudeau government reaffirmed its commitment to a balanced budget by 2019/20.[1]

To be clear, the budget balances proposed in the Liberal platform were by no means a high bar for the

1 For instance, the commitment for a balanced budget in 2019/20 was explicitly mentioned in the 2015 mandate letter to the Minister of Finance (Trudeau, 2015).

Figure 1: Federal budget balance ($ billions)—Liberal electoral platform compared to governance, 2016/17–2019/20



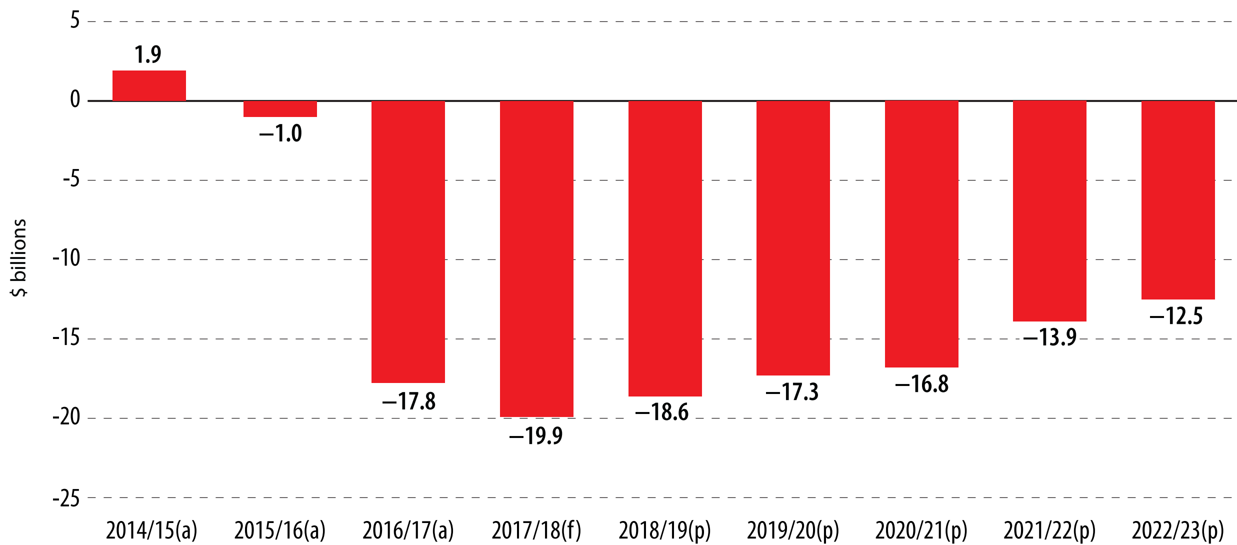
Sources: Liberal Party of Canada, 2015; Department of Finance, 2017a.

government to achieve. The federal government had already recorded a budget surplus of $1.9 billion in 2014/15, the last full fiscal year before the Trudeau government took office. The Trudeau Liberals essentially pledged to Canadians that, despite a growing economy, they would take the federal budget from a small surplus to deficit and that the deficits would be relatively small and short-lived.

Since taking office, the fiscal plan put forth by the Trudeau government has substantially diverged from the commitments of the electoral platform. The actions and plans to date are characterized by much larger deficits with no plan to balance the budget in the Liberals' first mandate. The Trudeau government's first full year in office (2016/17) recorded a budget deficit of $17.8 billion, which is 79.6% larger than what was outlined in the 2015 platform. The projected deficit for 2017/18 is $19.9 billion, essentially two times larger than the deficit presented in the 2015 platform; and the deficit for 2018/19 is $18.6 billion; more than three times what was initially proposed. The current fiscal plan now projects a budget deficit of $17.3 billion by the end of the Trudeau government's first mandate in 2019/20, as opposed to the small surplus of $1 billion pledged in the 2015 platform. Cumulatively, the Trudeau government is now planning $73.6 billion in total deficits over four years instead of the platform's $24.1 billion. That is more than triple the initial commitment (figure 1).

The rationale for the increased deficit spending given by the Trudeau government is that it will help improve economic growth, particularly through investments in infrastructure. However, in reality only a fraction of the deficit in 2016/17 (the last year of historical data) was spent on infrastructure. The Parliamentary Budget Office (2017) estimates that the federal government spent $1.9 billion on infrastructure in 2016/17. This represents just 10.7% of the 2016/17 deficit. In other words, nearly 90% of the deficit that year is for current day spending.

Figure 2: Actual and planned federal budget balance ($ billions), 2014/15–2022/23



Note: "(a)" indicates years of actual historical data; "(f)" indicates that the data is the latest forecast for that year; and "(p)" indicates that the data represents planned deficit.
Sources: Department of Finance, 2017a, 2017b.

Figure 2 displays the federal budget balance from 2014/15 to 2022/23, as delineated in the government's latest fiscal plan. The fiscal year 2014/15 is of note as it is the last year that the federal budget was in surplus ($1.9 billion). Midway through the following fiscal year, in 2015/16, the Trudeau government took office and immediately increased spending beyond what was planned by the previous government (Clemens, Palacios, and Veldhuis, 2018). The higher spending amounted to $7.8 billion, which was offset by higher than expected revenues of $5.2 billion (Dep't of Finance, 2015; calculations by authors). As a result, the Trudeau government posted a deficit of $1.0 billion in 2015/16 instead of the $1.5 billion surplus projected by the previous government for the same year. This means that the deficit in 2015/16—the first in an ongoing string of deficits—was largely the result of spending choices rather than declining revenues.

Beyond the first mandate, from 2020/21 to 2022/23, the government's current fiscal plan is to continue running deficits totalling over $10 billion each year. In fact, according to the Department of Finance's latest long-term fiscal projections, without a change in federal policies, the government will continue to run deficits each year until 2045/46 (Dep't of Finance, 2017c). Notably, the last long-term projections published by the Department of Finance before the Trudeau government took office pointed to budget surpluses over the same period (Dep't of Finance, 2014). This suggests there has been a major structural change in program spending given the long-term projections for economic growth and thus revenue performance did not change significantly. While Canadians were promised relatively modest deficits and then a small surplus in 2019/20, the Trudeau government has delivered much larger budget deficits with no plan to balance the budget over the course of the next 25 years.

The government's continued reliance on deficits is problematic for a number of reasons, not least of which is that it breaks a promise to Canadians who voted for three years of modest deficit spending,

not persistent deficit spending until 2045. There are real negative economic and fiscal consequences as well. Prolonged deficits during periods of economic growth exposes federal finances to risks particularly if an economic recession occurs. A recession would cause revenues to fall and certain types of spending (like Employment Insurance) to automatically increase, resulting in even larger deficits than already planned (Clemens, Palacios, and Veldhuis, 2018). A vicious cycle could then ensue characterized by persistent and growing deficits, increasing government debt, and rising interest payments. As Canada's experience in the 1970s, 1980s, and early 1990s shows, the ultimate result could be a situation where the government finds itself unable to balance the budget or restrain the growth of government debt. And empirical research finds that a growing government debt burden can adversely affect a jurisdiction's economic performance, which ultimately translates into lower levels of prosperity for its citizens.[2]

Finally, increased government debt can result in more of the tax collected being used to pay interest on the debt—even without the added complication of rising interest rates. In 2018/19, the federal government expects to spend $26.6 billion in interest on debt (the equivalent of 8.2% of total revenue), leaving fewer tax dollars available for spending on public services or tax relief (Dep't of Finance, 2017a).

2. Rapid growth in program spending—a contributor to larger and persistent deficits

A key driver of the larger and persistent federal deficits over the course of the government's current fiscal plan is the relatively rapid growth in program spending (that is, total federal spending minus interest payments on the debt). ***Figure 3*** displays actual and planned program spending from 2014/15 (before the Trudeau government took office) to 2022/23, the last year of projections in the current fiscal plan. Since the Trudeau government came into office, program spending increased from $253.9 billion in 2014/15 to $304.9 billion, the projection for the current year (2017/18). The $51 billion increase in spending equals total growth of 20.1% in just three years.[3] On a per-capita basis, the federal government is spending more in 2017/18 ($8,306) than at any other time in Canadian history except during the 2009 recession when, in fiscal year 2009/10, the government spent $8,375, just $69 more (Clemens and Palacios, 2017).

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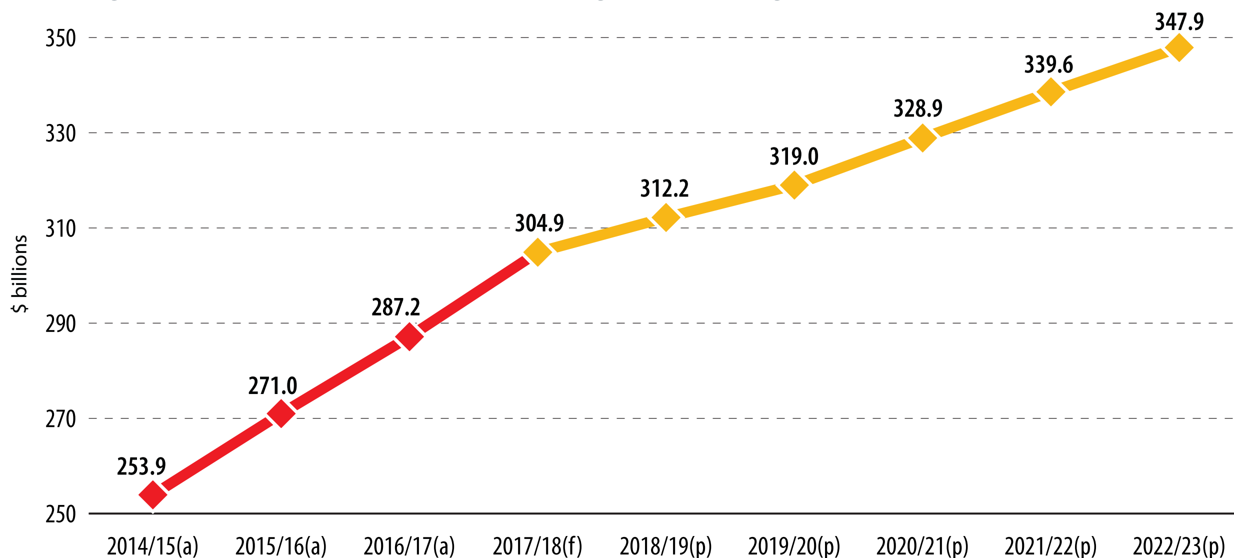
2 For a literature review of the evidence on the negative relationship between government debt and economic growth, see Lammam, MacIntyre, Ren, and Hasan, 2017.

3 Over this period, 37.0% of the increased spending is for major transfers to Canadian households, including pension benefits, transfers to parents with children, and employment insurance (Dep't of Finance, 2017a; calculations by authors). Another 22.1% of the increase in spending is for operation costs such as compensation for government employees, and 14.3% is for major transfers to other levels of government. And finally, about a quarter (24.9%) is for other transfers to households and governments including federal funding of provincial and local infrastructure projects as well as transfer programs such as the Working Income Tax Benefit. Overall, the bulk of the new program spending is for current day spending rather than investments in infrastructure, which is at odds with the Trudeau government's claim that deficit spending is helping grow the economy through new or improved infrastructure.

Figure 3: Actual and planned federal program spending ($ billions), 2014/15–2022/23



Note: "(a)" indicates years of actual historical data; "(f)" indicates that the data is the latest forecast for that year; and "(p)" indicates that the data represents planned deficit.
Sources: Department of Finance, 2017a, 2017b.

On an annual basis, program spending has increased by 6.3% each year from 2014/15 to 2017/18. By recent standards, that is significant annual growth in spending. For the preceding ten-year period (from 2005/06 to 2014/15), program spending grew by an average of 3.7%, much lower than the 6.3% figure over the past three years. If the unique post-recession spending increase of 17.1% in 2009/10 is excluded from the average, then the long-term trend is annual program spending growth of just 2.2%. In other words, the Trudeau government has increased program spending at an annual rate that is nearly three times the trend over the previous decade.[4]

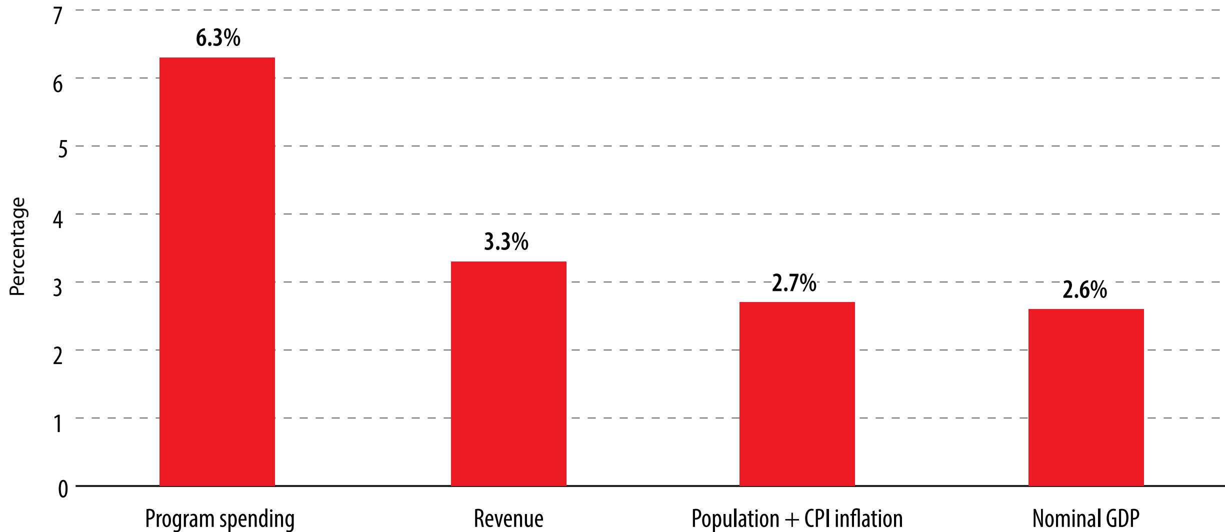
For further context, consider that the annual 6.3% growth in spending is nearly twice the growth rate of revenue (3.3%) (*figure 4*). Program spending growth has also outpaced the growth of economic output—increasing at nearly two-and-a-half times the rate of nominal GDP (2.6%). As a result, federal program spending as a percentage of GDP is up from 12.8% in 2014/15 to 14.3% in 2017/18. Moreover, program spending increased at more than twice the rate required to keep up with a growing population and increasing overall prices (inflation).

In the coming years, including the remaining time of its first mandate, the Trudeau government plans to moderate the rate of increase in program spending. From 2017/18 to the end of the fiscal planning period (2022/23), program spending is expected to increase from $304.9 billion to $347.9 billion (figure 3). That represents total growth of 14.1% over five years compared to 20.1% in the previous three years.

Figure 5 shows the actual and planned annual program spending growth from 2015/16 to 2022/23. After three years of at least 6.0% growth in annual spending, the government plans to increase

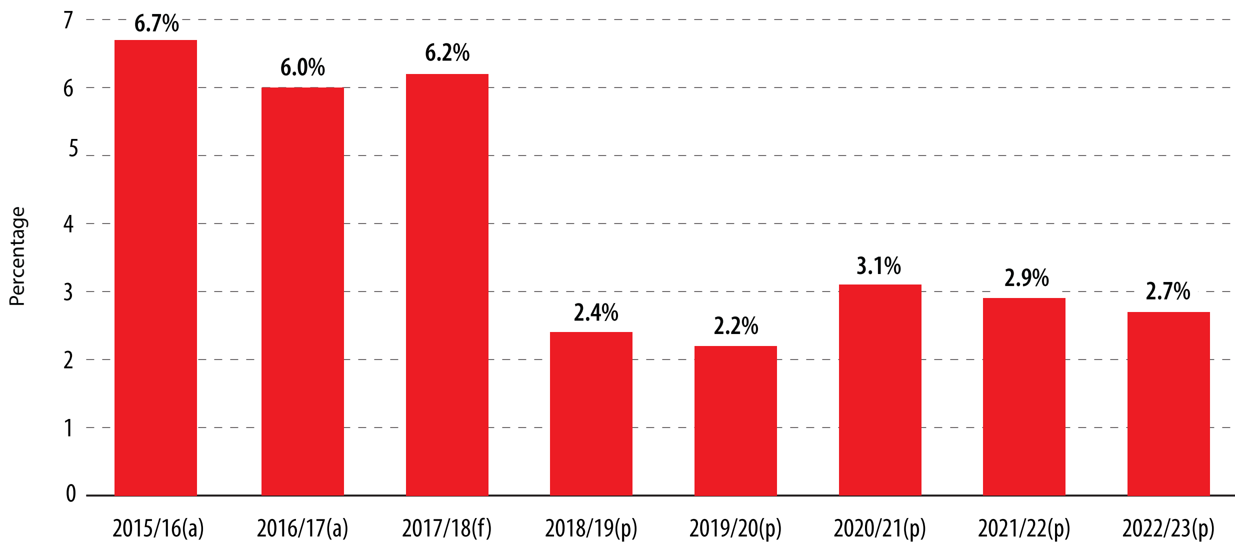
4 Data in this paragraph are sourced from Department of Finance, 2017b; calculations are by the authors.

Figure 4: Average growth (%) in program spending, revenue and economic indicators, 2015/16–2017/18



Note: Nominal GDP for 2015 comes from Statistics Canada, 2017b; the rest of the GDP data come from Department of Finance, 2017a.
Sources: Department of Finance, 2017a, 2017b; Statistics Canada, 2017a, 2017b; calculations by authors.

Figure 5: Annual growth (%) in program spending, 2015/16–2022/23



Note: "(a)" indicates years of actual historical data; "(f)" indicates that the data is the latest forecast for that year; and "(p)" indicates that the data represents planned deficit.
Sources: Department of Finance, 2017a, 2017b.

program spending by 2.4% in 2018/19 and 2.2% in 2019/20. Put differently, the Trudeau government plans to increase spending by an average of just 2.3% annually in the remaining years of its mandate, a dramatic departure from the 6.3% annual growth averaged during its initial years in office. Indeed, in the remaining years of the mandate, the rate of spending growth is expected to be approximately a third of that in the initial years. While program spending growth from 2018/19 onward is forecast to moderate compared to the first three years, this is still not sufficient to return the federal government to a balanced budget. Crucially, the more moderate growth rates apply to a higher level of spending so the actual increases in spending remains significant.[5] And the Trudeau government has not outlined how it plans to moderate spending growth in the future, which again would diverge from its actual spending behaviour in the past.

3. Returning to the promised balanced budget by 2019/20

While the current fiscal plan abandons the Trudeau government's election promise to return to a balanced budget in 2019/20, a balanced budget by the end of the first mandate is not out of reach. This can be accomplished by either reducing planned spending on programs or by increasing revenues through higher tax rates (or increased economic growth), or some combination of these. Since the government does not directly control economic growth, there are really only two possible direct approaches: restrain spending or raise tax rates. Because increased tax rates do not guarantee increased revenues since behavioural responses can offset expected revenues from the higher rates, restraining spending is a better approach for many reasons. First, as noted earlier, the Trudeau government has increased spending rapidly over the past three years and this is a key source of the larger and persistent deficits. So restraining spending would, in fact, address a significant source of persistent deficits.

Second, historical cases from Canada and other industrialized countries show that efforts to eliminate deficits driven primarily by spending cuts rather than tax rate hikes tend to be more successful in reducing the burden of government debt (Alesina and Ardagna, 2010). Moreover, a recent review of the empirical literature finds that governments that rely more on spending cuts or restraint when attempting to eliminate deficits are less likely to harm the economy (in terms of the effect on GDP) or create a recession compared to efforts that rely more on tax rate hikes (Alesina, Favero, and Giavazzi, 2018).[6] In some instances, spending reductions can contribute to an expansion of the economy: Alesina and colleagues identify Canada's efforts in the 1990s to reduce budget deficits primarily through spending reductions as an example where such action led to a faster growing economy. Finally, raising tax rates would be inadvisable as doing so would hurt Canada's economic competitiveness, particularly given the recent sweeping tax reform in the United States.

5 From 2018/19 to 2022/23, the average annual increase in program spending is $10.3 billion compared to annual increases of $16.2 billion from 2015/16 to 2017/18.

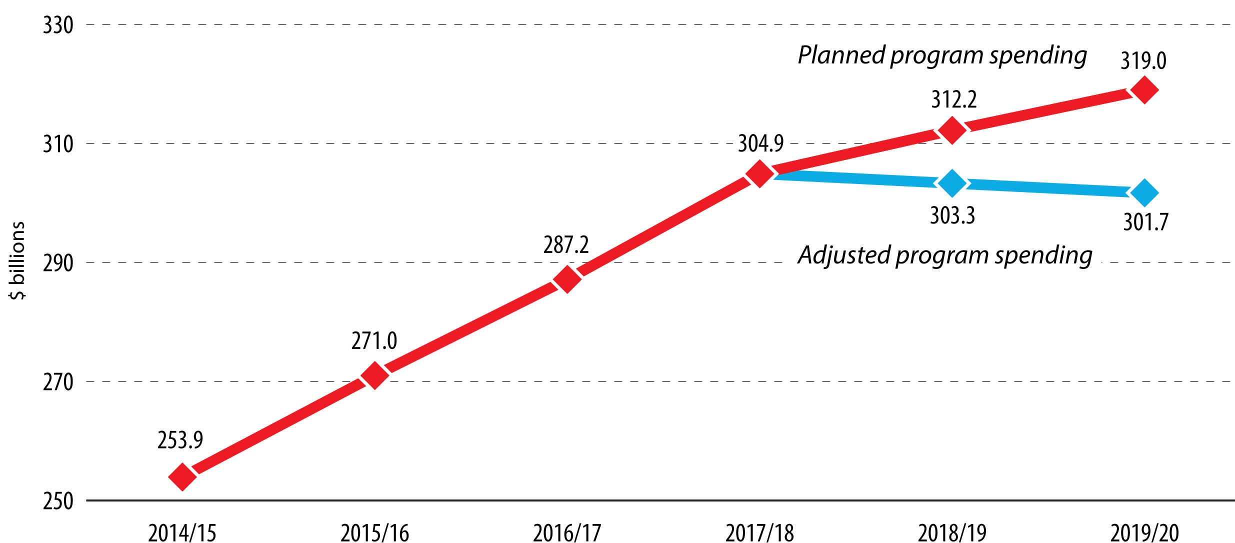
6 This could be, in part, because spending reductions boost consumer and investor confidence and reduce uncertainty regarding higher future taxes that are needed to repay the deficit and debt (Alesina, Favero, and Giavazzi, 2018).

Returning to a balanced budget by 2019/20 through spending reductions would mean reducing the current (2017/18) level of program spending from $304.9 billion to $301.7 billion—a difference of just $3.2 billion or 1.0% over two years. ***Figure 6*** displays the trajectory of program spending needed to achieve this goal as well as the actual and planned program spending over the course of the Trudeau government's first mandate. Figure 6 assumes that the government will spread the spending reduction evenly across two years, so that each year would include a 0.5% reduction in spending compared to the previous year.

The 1.0% total reduction in spending over two years is modest compared to what was accomplished by the federal Liberals under the leadership of then Prime Minister Jean Chretien in the 1990s. The Chretien government inherited the result of decades of chronic deficits and a growing crisis in government finances (Clemens, Palacios, Lau, and Veldhuis, 2017). Specifically, when the Chretien Liberals formed government in 1993/94, the last time the federal government recorded a budget surplus was in 1969/70—nearly three decades earlier. After nearly three decades of budget deficits, federal debt (accumulative deficits) grew from $20.3 billion in 1970/71 to $527.9 billion in 1993/94, equivalent to 71% of the economy. The high level of debt meant a considerable amount of tax revenue was used to pay annual interest on that debt. In 1993/94, annual interest payments consumed one third of all federal revenues (Dep't of Finance, 2017b).

The Chretien government responded to this challenge by undertaking a review of program spending to identify areas where spending could be reduced (Clemens, Palacios, Lau, and Veldhuis, 2017). A comprehensive spending review was introduced in the 1994 budget and covered all departmental program spending. Government spending was evaluated on the following six metrics:

Figure 6: Planned federal program spending ($ billions) and program spending adjusted to achieve a balanced budget, 2014/15–2019/20



Sources: Department of Finance, 2017a; calculations by authors.

1. Does the spending serve the public interest?
2. Is it necessary for government to undertake?
3. Is it an appropriate role for the federal government?
4. Is there scope for partnership with the private sector?
5. Is there an opportunity for increased efficiency?
6. Is the spending affordable?

As a result of this evaluation, program spending was reduced by 9.7% from 1994/95 to 1996/97 and the budget was balanced the following year. The Trudeau government could undertake a similar, although less ambitious, review of program spending to identify savings with the goal of reducing spending by 1.0% over two years.

One area that should be under immediate consideration for spending reductions is subsidies to businesses—often referred to as "corporate welfare". While politicians often claim business subsidies improve economic performance or provide well-paying jobs, the reality is that subsidies create distortions in the economy by giving advantages to particular businesses or industries. This puts businesses that may be otherwise more innovative or productive (but lack the contacts or political clout to receive subsidies) at a disadvantage. Academic evidence finds that corporate welfare generally does not stimulate the overall economy (Milke, 2007). Instead, it redirects resources from particular businesses or industries to those favoured by the government. Business subsidies can also create irritants with other countries with which Canadians trade, putting at risk Canadian access to foreign markets such as the United States.

A recent study by John Lester (2018) identified $29 billion in business subsidies—both spending and tax measures—in 2014/15 from the federal government and Canada's four largest provinces (British Columbia, Alberta, Ontario, and Quebec). The federal share represents $14 billion. Lester reviewed the evidence on such programs and concluded that only a third of the business subsidies offered by the federal government and the four provincial governments succeeded in raising real income. That means there is considerable potential to find savings.

Another area of government activity that should be considered for spending reductions is infrastructure. The Trudeau government has announced plans for infrastructure that involves $7.4 billion in new spending in 2018/19 and $5.7 billion in 2019/20 (Dep't of Finance, 2017d).[7] The stated goal of this new spending is to improve economic growth. In principle, sound infrastructure can increase long-term economic growth by improving the economy's productive capacity through more efficient transportation networks for individuals and commerce. However, little of what the government plans to spend is for such a trade and transportation infrastructure (Lammam and MacIntyre, 2017). Of the new spending, only 8.4% in 2018/19 and 12.2% in 2019/20 is slated for trade and transportation infrastructure (Dep't of Finance, 2017d). Instead, the bulk is going to so-called "green" and "social" infrastructure, the latter including projects such as social housing and community centres. While these initiatives may

7 This spending is in addition to spending on infrastructure programs introduced by the previous government, which amounts to over $10 billion in 2018/19 and approximately $8 billion in 2019/20 (Dep't of Finance, 2016).

be appreciated by the communities in which they are built, they are unlikely improve productivity and grow the economy.

A third way that the federal government can find savings is by aligning the wages of federal employees more closely with wages of comparable workers in the private sector. A recent study found that government employees in Canada receive, on average, a 10.6% premium compared to similar private-sector workers (Lammam, Palacios, Ren, and Clemens, 2016). This wage premium exists, even after differences such as age, gender, education, tenure, experience, and type of work between individual workers in the two sectors are taken into account. It is also on top of the more generous pensions and other benefits such as job security found in the public sector. Better matching what the private sector pays comparable workers would yield considerable savings.

Conclusion

In their 2015 election platform, the Trudeau Liberals pledged three years of relatively modest deficits and a return to balance by the end of the first mandate in 2019/20. Since forming government, the Trudeau Liberals have delivered or planned much larger deficits with no return to a balanced budget. In fact, the Trudeau government has essentially tripled the cumulative size of the deficits over what was promised. Yet, it is still possible for the Trudeau government to deliver on its end-of-mandate promise to balance the federal budget. With modest adjustments to spending, it could still keep its promise to Canadians and balance the budget in 2019/20.

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