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Backgrounder

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The $22.5 Billion Question: Will Exposure Make Future Federal Surpluses Evaporate?

by

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In his fall update next week, Finance Minister Paul Martin will reveal, for the first time since the federal budget went into surplus, an estimate of how much room there is in the budget for tax cuts and spending hikes over the next five years. The amount will be impressive — perhaps $22.5 billion — offering a unique chance to cut federal debt and reform Canada's taxes. Seizing that opportunity, however, means ensuring that exposure does not cause the $22.5 billion to evaporate.

Setting a New Fiscal Framework

The minister's presentation will open a new stage in the debate over Ottawa's fiscal priorities. For the past six years, the battle against unsustainable deficits has driven him to forecast only two years ahead and to err on the cautious side, virtually guaranteeing that, come hell or high water, the budget targets would be hit.

While highly successful in fighting deficits, this tactic is ill suited to an era of rising surpluses. A two-year time-frame is very short, while the pessimistic forecasts of recent budgets hurt their credibility. Worse, Ottawa has used last-minute spending to eliminate surpluses that were not forecast, distorting both its financial statements and its spending priorities.

The minister and his officials have responded to these problems with a useful new approach, working with private sector forecasters to arrive at a consensus on the fiscal outlook and the "prudence cushion" that would prevent nasty surprises pushing the budget back into deficit. The results of this exercise will be a highlight of Mr. Martin's update: the first straightforward estimates, since the era of surpluses began, of how much room there is for "good news" in the budgets of the next five years.

The Good News: $22.5 Billion

The precise numbers will be a secret until the day of the update. But it is safe to say they will look impressive. A baseline projection, with fiscal policy on autopilot, would have spending on programs growing with population and inflation, and taxes (thanks to bracket creep) taking a gradually growing share of the economy. Under those circumstances, a middle-of-the-road forecast — real growth and inflation both averaging a little over 2 percent, and interest rates averaging a little under 6 percent — produces surpluses that start around $5 billion in the current fiscal year and rise by about $5 billion in each subsequent year, reaching almost $30 billion by fiscal year 2004/05.

Surpluses that big provide plenty of protection against slumps and spikes in interest rates. Again, the prudence cushions from the Finance Department's exercise will not be known until the minister reveals them. But a C.D. Howe Institute economic model provides guidance about how robust fiscal outcomes are to surprises. Our forecasts suggest that, even in the most uncertain final year, the odds of having a surplus more than $5 billion below the baseline figure are less than one-in-six. Clearly, this scenario gives Ottawa considerable room to move. This approach to calculating prudence cushions suggests that, if Ottawa aimed for budget surpluses of $6–7 billion between now and fiscal year 2004/05, the odds of avoiding a deficit would be well over 90 percent. If the Finance Department's exercise yields similar numbers, the fall update could show room for tax cuts or new spending of $4.5 billion annually, or $22.5 billion over the next five years.

How Fast Can $22.5 Billion Vanish?

The moment the new figures are released, the risks of this approach — and the reason for Mr. Martin's reluctance to adopt it sooner — will become obvious. If we are not careful, Canadians may see a payoff from budget surpluses much lower than $22.5 billion.

An easy way to lose part of the payoff would be to continue spending unneeded prudence cushions in year-end binges. The surest way to make recent budget victories permanent is to pay down debt: even surpluses of $6–7 billion would reduce Ottawa's interest bill by some $2 billion after five years. Spend the money instead, and some of the good news in upcoming budgets will disappear.

Much more of the payoff would be at risk if the influence over spending of *ad hoc* decisions and various courts and tribunals continues to grow. Program spending in fiscal year 1998/99 was almost $7 billion above the 1998 budget's projections, and the recent multibillion dollar pay equity decision shows how far Parliament has allowed its control of the public purse to slip. It does not take many $7 billion overruns to dispose of $22.5 billion.

Inept tax changes pose further risks. For example, Ottawa delivers the National Child Benefit through the tax system and nets its cost against revenues in the budget, leading some to advocate "cutting taxes" by expanding the benefit. But the benefit is actually a transfer that is clawed back from recipients as their incomes rise, which *raises* their marginal tax rates: most proposals for enriching the benefit would actually worsen the problem. Raising the payroll tax burden of the employment insurance program by adding more non-insurance features also threatens jobs.

Five years is long enough for clumsy tax changes to dampen Canada's economic prospects, causing more of that $22.5 billion to disappear before Canadians can enjoy it.

Protecting Our Fortune

To stop the evaporation of the benefits of federal surpluses, the finance minister needs to act aggressively to preserve them. To start, he should state explicitly that budget surpluses

are smart fiscal policy. As with the current $3 billion contingency reserve, unneeded prudence cushions should pay down debt. The lower interest costs that will result are the single surest bet fiscal policy offers. If a strong economy produces surpluses bigger than $7 billion over the next few years, the total good news by fiscal year 2004/05 could be greater than $22.5 billion.

Second, the minister must remind his colleagues that controlling public finances is a never-ending task. *Ad hoc* spending and the increasing influence of courts and tribunals in Canadian politics are eroding Parliament's fiscal control just as surely as mounting interest costs once did. The $22.5 billion is Parliament's to dispose of as it sees fit, but only if it asserts its right to do so.

Finally, the minister needs to make smart tax cuts a priority. Just as inept tax changes could shrink the budget payoff, adept ones could make it grow. If lower personal tax rates, more competitive business taxes, and reduced taxes on saving and investment boost job creation, investment, and growth over the next five years, the surplus will be larger yet.

Mr. Martin's presentation of a new, longer-term fiscal framework will be a welcome change in Ottawa's budget policymaking. But it poses a risk: will the multibillion dollar payoff in the federal budget evaporate as soon as it is exposed? That is the $22.5 billion question.

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