

Flaherty's plan on shaky ground

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On August 9th, 2011, the *National Post's* editorial page celebrated the continuation of Canada's AAA credit rating, in light of the US downgrade to AA+ (*National Post*, 2011).¹ While there is no doubt that our fiscal health is relatively better than that of the United States and many European countries, recent market volatility combined with declining commodity prices should not make Canadians too complacent.

The *Post* noted that Canada had learned its lesson years ago. However, the way we see it, the federal government is making the same basic mistake: pinning hopes for a balanced budget on a combination of significantly higher future revenues while trying to slow the growth in spending.

In June 2011, the federal government tabled a plan to balance the budget in five years (Department of Finance, Canada, 2011).² To get there, the Conservatives forecasted revenues to grow at a robust average rate of 5.6% over the next five years, while planning to hold program spending increases to an average rate of 2.0%.

The problem with this plan is that while the federal government directly controls the amount it decides to spend—though Canadians should exercise healthy scepticism as the Conservatives' track record on spending suggests it will be unable to hold the line at 2.0%—the government is exposed to revenue shocks that are beyond its control.

A balanced budget plan that relies on robust average revenue growth of 5.6% is one with significant risk and little-to-no upside potential. Lower than forecasted revenue growth will mean larger deficits for a much longer period and significantly more government debt.

As we previously pointed out in our analysis of the June budget, "The same approach did not work in the 1980s and early 1990s. Successive

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The Canadian government must quickly balance its budget

federal governments failed to balance the budget by trying to slow the growth in spending while hoping for higher revenues” (Veldhuis and Lammam, 2011).

Like the incumbent Conservatives, the Progressive Conservative government in the late 1980s and early 1990s was at least notionally predisposed to lower levels of government spending and balanced budgets. However, failure to eliminate the deficit came from the Progressive Conservative’s inability to constrain spending growth coupled with lower than expected revenues. That ultimately resulted in ongoing deficits, mounting debt, and a loss of Canada’s AAA rating in 1994.

Now, just months after the 2011 budget was tabled, the current government’s fiscal plan is facing similar risks with signs of a slowing US economy and the possibility of a double-dip recession increasing. Given that Canada’s economy is tied heavily to the US, any material slowdown in the US will likely have a negative impact on the Canadian economy, federal revenues, and the Conservatives’ deficit-reduction plan.³

To reduce the frailty of the current fiscal plan and to set Canada apart from the rest of the world, the Canadian government must quickly balance its budget. Finance Minister Flaherty can use the government’s fall economic and fiscal update to do just that—and balance the books in two years, not five.

First, Flaherty should ensure that program spending is returned to pre-stimulus levels. This can be achieved by greatly expanding the government’s *Strategic and Operating Review*, currently a one-year review of program spending—excluding transfers to individuals and governments—which proposes to find a mere 2% in savings from the \$352.5 billion in departmental spending planned from 2012–13 to 2014–15.

The expanded *Strategic and Operating Review* ought to prioritize spending so that important areas are spared deep cuts while lower priority areas carry a greater burden of the spending reductions. A good starting point is to significantly reduce, or eliminate, corporate subsidies, which have grown substantially under the Conservative regime.⁴

A two-year, balanced budget plan would substantially reduce the risks associated with a revenue shock like a slowing US economy. Such a plan also provides the Conservatives with upside potential. That is, if revenues rebound strongly, the Conservatives could then implement a much-needed, multi-year plan to reduce personal income taxes.

In the wake of the American credit downgrade, the stock market plunge was an arresting reminder of the

risks facing the Canadian economy. The US economy is looking ever more fragile, sovereign debt concerns are growing in Europe, and commodity prices are softening; all reasons why Canadians should feel increasingly uneasy about the government’s fiscal plan. The newly minted Conservative government should use its majority to implement the type of balanced budget plan that the Prime Minister and his colleagues once championed while they were members of the opposition.

Notes

- 1 A credit rating evaluates the credit worthiness of an issuer of debt, in this case government. AAA is the highest rating meaning the debt issuer is not likely to default.
- 2 Please note that, unless otherwise indicated, all data referenced in this article are sourced from Department of Finance, Canada (2011).
- 3 Interestingly, the Conservatives’ plan is built on the assumption that the US economy will grow robustly at an inflation-adjusted average rate of 3.2% over the next five years—faster than the Canadian economy at 2.7%.
- 4 Federal subsidies to the auto sector—just one of many sectors that receive corporate welfare—grew by around \$10 billion in 2009-10 (see Department of Finance, Canada, 2010).

References

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